MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

24 APRIL 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

Macroeconomic developments

In March 2012, the consumer price index stood at 5.5% and core inflation at 5.0%. Both headline and core inflation fell by 0.4 percentage points relative to the previous month. The decline in core inflation in March was largely driven by lower processed food prices due to a base effect and developments characterising the month. Services price inflation remained modestly positive. These effects were partly offset by higher alcohol and tobacco prices, reflecting the increase in excise taxes. The concerted price increases at the beginning of the year, simultaneously with the increase in VAT, were partly reversed, as confirmed by developments in the prices of individual items. Measures capturing underlying inflation developments fell to a range between 3% and 4%, after rising sharply in January.

Industrial production rose mildly in February. Seasonally adjusted, production grew by 0.4% relative to January. Although output was up 1.1% on a year earlier, this was driven mainly by the leap-day on 29 February: after adjusting for calendar and seasonal effects, the annual index fell by 3.1%. The trend in industrial production and sales has been downwards in recent months. The decline in exports, previously the driving force behind growth, was partially offset by stabilising domestic sales. The goods balance improved in February, reflecting stagnating exports and falling imports, expressed in euro terms. The deterioration in Hungary's terms of trade slowed in January. Developments in the terms of trade continue to be shaped by changes in energy prices.

Adjusted for working-day variations, the volume of retail trade rose by 0.6% in January relative to a year earlier. Total sales (which also include sales of vehicles and components), exhibiting a closer correlation with consumption expenditure, were 0.7% higher than a year previously. Real income of households, one of the most important macroeconomic factors determining household consumption growth, fell in January. The administrative wage increases at the beginning of the year counterbalanced the impact of the increase in taxes on employees with below-average income; however, the pick-up in inflation early in the year eroded the purchasing power of incomes. As seen at the end of last year, the sharp depreciation of the forint may have contributed to an increase in purchases by non-resident households.

In February, gross average earnings rose by 6.9% in the total economy. Private sector earnings grew by 8.9% and government sector earnings by 2.1%, with irregular pay increasing even more strongly than average earnings. The rate of gross average earnings growth picked up, mainly reflecting the base effect of low bonuses paid last February. The high index for regular pay continued to result mainly from the significant administrative wage increases for low-income workers at the beginning of the year. This is suggested by the fact that − despite the different conditions for activity − earnings growth in manufacturing and market services rose at a broadly similar rate. The monthly indicators, capturing underlying trends by eliminating the effect of the minimum wage increase, do not show a further pick-up in earnings. The increase in companies' labour costs due to the administrative increase in wages was almost fully offset by fiscal compensation. Consequently, the rapid increase in the rate of earnings growth does not necessarily mean an equivalent increase in their labour costs. Net real earnings may have fallen by around 2.0% in the first few months of the year.

Financial market developments

Sentiment in international financial markets has deteriorated significantly since the Monetary Council's previous policy decision. Risk premia, i.e. the extra return required by investors on risky assets, rose across markets. Equity indices fell in both developed and emerging markets. In emerging markets, bond spreads rose and currencies depreciated. The VIX index, an indicator of investor risk aversion, has also risen sharply in recent weeks.

Market sentiment continues to be driven by the financing risks facing European countries in a weak fiscal position, on the one hand, and by US macroeconomic data and expectations related to potential further measures by the Fed to stimulate the economy, on the other. In the euro area, market participants began to focus on Spain as uncertainty surrounding Greek government debt diminished. Spanish bond yields rose significantly as auctions showed mixed results, in parallel with mounting risks related to the implementation of the government's measures to improve the fiscal position in recent weeks. In the US, the latest macroeconomic data, most notably those on unemployment, were on the weak side, which, according to market participants, increased the likelihood of another quantitative easing programme, although the minutes of the Fed's latest interest rate-setting meeting suggested that policymakers took a somewhat more cautious approach.

There are several signs suggesting that investors' attitude towards emerging market assets has deteriorated in recent weeks. Emerging country bond spreads increased and currencies depreciated against the US dollar. The EMBI bond spread rose by some 40 basis points and the dollar appreciated by 2%−3% on average against emerging market currencies. Meanwhile capital flows from developed to emerging markets slowed significantly. The deterioration in investor sentiment also hit the Central and Eastern European region. If they continue, these adverse trends may also adversely affect the Hungarian economy.

The deterioration in global investor sentiment represents a particularly important risk to Hungary, because it may contribute to a further increase in perceptions of the risks associated with the economy which is already viewed as being more risky due to domestic factors. The fall in investor risk appetite was also reflected in movements in CDS premia. The five-year Hungarian CDS premium rose by some 60 basis points to 595 basis points. This increase was larger than the average rise seen in the countries of Central and Eastern Europe. Perceptions about the Hungarian economy continue to be driven by global financial market developments. The slight increase in perceptions of risks facing the economy relative to other countries of the region mainly reflected a structural factor, namely that Hungarian asset prices tend to be more susceptible to changes in global investor sentiment than the average. Developments related to negotiations on a credit line from the EU and IMF continue to be the most important country-specific factor in terms of perceptions about the economy. No significant progress has been made in this area in recent weeks. Overall, the effects of the individual pieces of contrasting information were offsetting.

In the past month, the unfavourable phenomenon whereby spreads on Hungarian foreign currency-denominated bonds remained at levels some 100 basis points higher than would be justified by the CDS premium has remained. The rate on the five-year euro-denominated bond rose by roughly 25 basis points, implying a spread of 785 basis points over the yield on a German government bond of the same maturity. Non-resident holdings of Hungarian government securities have increased significantly in recent weeks, which is a positive development. However, increased holdings reflected in part transactions between foreign parents and their Hungarian subsidiaries, rather than greater demand by end-investors, which altered the picture slightly.

Since the last interest rate decision, the forint has depreciated against the euro by some 1%-1.5% to near the EUR/HUF 300 level. The degree of the forint's depreciation was slightly greater than that of other currencies of the region. The exchange rate fluctuated between EUR/HUF 291 and 299, a narrower range than in previous months. Implied volatilities of foreign currency options fell slightly. The FX swap market showed a more favourable picture than in previous months: the premium on euro funding at the overnight maturity fell to nearly 70 basis points and stabilised at around 150 basis points at maturities of 3–6 months.

In the government securities market, long-term yields have risen by a total of 15–20 basis points in recent weeks to near 9%. Short-term yields remained broadly unchanged, remaining at around 7.5%.

Market rates reflected a slight increase in expectations of an official rate hike in the past month. Although the differential between three-month BUBOR and the base rate remained unchanged at around 20 basis points seen at the end of March, forward interest rates for six-month loans starting in two and three months' time rose by 5–10 basis points. Based on this, market expectations of the central bank base rate for the next three months are estimated to be in a 0–25 basis point range, with the likelihood that interest rates will be left unchanged being smaller than previously.

According to the latest Reuters poll, analysts' consensus forecast is for the base rate to remain unchanged at the Monetary Council's next policy meeting. Longer-term expectations changed little in the past month. The majority of analysts expect the base rate to be 6.5% at the end of the year, with one respondent expecting it to be below and another expecting it to be above that level. One-third of respondents think it likely that interest rates will be left unchanged and one-third expect it to be lowered by 25 basis points. The median expectation is that the base rate will be 6.0% at the end of 2013.

Position of the banking sector

Bank lending to the corporate sector fell further in March, i.e. there continued to be little sign of a turnaround in lending. Irrespective of loan amount, average interest rates on forint corporate loans rose in the first two months of the year. The net monthly change in household lending volumes stabilised as the early repayment programme ended, but the decline in the net outstanding stock of lending was greater than the average of months preceding the early repayment period. Net new forint lending was close to zero in March, after essentially being positive throughout the period since the onset of the crisis. The decline in new lending may have contributed to this negative effect, as indicated by signs in data on gross lending by the banking sector in February. Interest rates on forint mortgage loans rose in the first two months of the year.

Based on preliminary data, external liabilities of the seven largest banks rose in March after falling in previous months. According to the latest set of data for the entire banking sector, external liabilities fell sharply in February, accounted for in full by credit institutions operating as limited companies. However, the stock of external liabilities fell again in the first part of April. The sustained decline in the external liabilities of the Hungarian banking sector has been the most severe in the region, with the gap between Hungary other countries increasing. Despite stalling in March, the decline in external liabilities may impede the recovery in lending. Weak credit supply continues to reflect banks' low willingness to lend; however, mainly on the liquidity side, deteriorating lending capacity increases the risk of a severe credit crunch, primarily in the corporate segment, due to the outflow of external funds.

Banks have met the regulatory liquidity ratios introduced in January 2012. In the event of a low-probability complex stress situation which simulates the simultaneous occurrence of a financial market turmoil, a rush withdrawal of deposits and an exchange rate shock, the sector's aggregate liquidity buffer remains positive, although its level falls below the regulatory requirement. The banking sector's foreign currency liquidity position is much worse than its total liquidity position, which poses another risk. In an extreme case it may occur that exchangeability between currencies becomes difficult, which could result in significant foreign currency liquidity needs under stress.

Cumulated within-year profits of the banking sector were positive in the first three months of 2012. Accordingly, in February and March banks managed to absorb the severe losses incurred in January. However, the ratio of loss-making banks continues to be high. The capital adequacy ratio for end-February was at a historically high level. According to the stress test, the banking sector would require additional capital of HUF 83 billion in the event of a persistent, two-year shock, in order to meet the 8 per cent minimum capital requirement. Capital needs are highly concentrated.

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

The Monetary Council judged that the Hungarian economy was essentially stagnating, with growth only likely to resume in 2013. The level of output would remain below its potential over the period ahead. The consumer price index was expected to rise significantly this year, reflecting the effects of increases in VAT and excise duties last year and this year as well as the depreciation of forint exchange rate in the second half of 2011 and the rise in oil prices in early 2012. The latest Government measures, announced as part of the Structural Reform Programme, were likely to result in an increase in inflation in 2013, while causing aggregate demand to contract, which in turn might reduce the risk of second-round effects on inflation. The Council continued to consider it important that an agreement between the Government and the EU and IMF be reached as soon as possible. Such an agreement would have a favourable impact on the outlook for growth and inflation and increase the room for manoeuvre in monetary policy, in addition to reducing the risks associated with financing the government debt.

Council members agreed that the economic data released since the previous interest rate decision had not materially altered the baseline projection presented in the March issue of the *Quarterly Report on Inflation*. However, several members noted that the consumer price index for March appeared to confirm the assumption in the *Report* that the pass-through of the VAT increase to prices was faster and greater than previously thought. There was agreement among members that an overall assessment of the macroeconomic effects of the Structural Reform Programme, announced on the day before the meeting, could only be performed during the next projection round. However, one member noted that, based on the government forecast updated in connection of the announcement of the Programme, inflation was likely to increase in 2013 as an effect of the measures. Another member commented that the austerity measures could lead to an increase in inflation and a slowdown in growth across Europe and could therefore reduce the responsiveness of monetary policy to inflation in euro-area member countries.

Council members agreed that in the current situation factors affecting perceptions of risks were of key importance. Several members noted that the outcome of negotiations with the EU and IMF might change foreign investors' perceptions of the risks facing the Hungarian economy in the short term. The meeting between the Hungarian Prime Minister and the President of the European Commission on the day of the Council's interest rate-setting meeting might stabilise and even improve perceptions about Hungary, if an announcement released following the discussion showed that progress had been made and negotiations on a credit line could start shortly. However, if the meeting did not produce a breakthrough, financial market tensions could result in a rapidly deteriorating path.

In the Council's judgement, the measures of the Programme would also affect perceptions of the risks associated with Hungarian assets in the longer term, as market participants assessed information related to the Programme. Several members argued that the Programme was a step towards achieving sustainable fiscal and debt paths, which would help bring closer the conclusion of the excessive deficit procedure against Hungary and contribute to an improvement in perceptions about the economy. It was also argued that the Programme would only have a clearly positive impact on perceptions if the market judged that it contained sustainable measures and did not result in a significant deterioration in the economy's growth potential. On the whole, it was currently difficult to assess the likely impact of the measures on perceptions about the economy.

In terms of risk perceptions, some members cautioned that a greater amount of forint-denominated government securities had to be issued this year, due to the decision to postpone issuances in foreign currency, which might increase financing risks over time. It was also argued that the difficulties with financing were also reflected in movements in CDS premia and foreign currency bond yields recently, which indicated that perceptions about the Hungarian economy may have deteriorated relative to other economies. Several members cautioned that global risk appetite had also fallen recently, due to negative assessment of the debt position of euro-area periphery countries.

In discussing the monetary policy options, the majority of members agreed that the data released over the past month and developments in perceptions of risks did not warrant a revision of the baseline projection in the March *Report*, and therefore maintaining the central bank base rate was still justified. Several members thought that a successful outcome of the negotiations with the EU and IMF was clearly in the interests of the Hungarian economy, and therefore there was no doubt that positive news would be released about the negotiations. This would clearly influence the room for manoeuvre in monetary policy.

However, several members noted that, based on a quick assessment, the measures included in the Structural Reform Programme might increase inflation risks in 2013. One member assessed that the position of the financial intermediary system was still fragile, the outflow of funds continued at a rapid pace, there were perceptible tensions in the swap market and lending conditions were deteriorating. In this situation, an increase in the base rate to signal the stance of policy would contribute to a reduction in inflation risks, a fall in yields at the longer end of the curve and an easing in financing strains. Other members did not support an immediate increase in the base rate; however, they agreed that if the risk premium and inflation risks continued to rise, then this might necessitate monetary policy responses in the future. One member firmly rejected the option of raising interest rates and argued in favour of reducing rates, as an interest rate increase would send the economy into recession, which would add to inflation through spiralling effects rather than reducing it.

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 29 May 2012. The minutes of that meeting will be published at 2 p.m. on 13 June 2012.