MINUTES

OF THE MONETARY COUNCIL MEETING

29 MAY 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 April, the consumer price index stood at 5.7% and core inflation at 5.1%. Headline inflation rose by 0.2 percentage points and core inflation by 0.1 percentage point relative to the previous month. Increases in the prices of items determining underlying inflation developments moderated after the sharp rises at the beginning of the year, but the annual indices remain at elevated levels. Higher core inflation relative to March reflected the increase in tobacco prices, with its effect being offset by lower food price inflation. Seasonally and tax-adjusted month-on-month inflation of tradables picked up again in April after slowing in the previous month. Developments in services prices confirmed that some of the price increases planned for later months may have been brought forward to the beginning of the year as a result of the increase in VAT. Measures capturing underlying inflation developments, adjusted for taxes, were around 3% in the month.

Industrial production rose modestly in March. Seasonally adjusted, production grew by 0.6% relative to February. Output fell by 1.6% relative to the same period of the previous year, but after adjusting for calendar and seasonal effects, the annual index rose by 0.6%. Industrial production declined in the first quarter as a whole, which may have contributed to the contraction in GDP. Exports, which had previously been the driving force behind growth, nearly stagnated in the period; however, the monthly indicators suggest that exports may recover in the coming months. The goods balance deteriorated in March, as imports grew faster than exports. The deterioration in Hungary's terms of trade slowed in March, mainly reflecting the drop in energy prices.

In March, gross average earnings grew by 2.7% in the total economy: private sector earnings rose by 5.8%, while government sector earnings fell by 4.5% relative to the same period of the previous year. The growth rate of regular pay in both the private and government sectors declined sharply relative to early 2012. In the private sector, the significant rise in the wage index due to the administrative wage increases at the beginning of the year was partly reversed. Regular pay growth also slowed. The monthly measures capturing underlying movements do not suggest further acceleration in earnings growth. Companies adjusted to the rise in labour costs due to the administrative wage increases at the beginning of the year by reducing irregular pay components. Fringe benefits also fell, in addition to bonuses.

Adjusted for working-day variations, the volume of retail sales was 1.4% lower in February than a year earlier. Total sales (which also include sales of vehicles and components), exhibiting a closer correlation with consumption expenditure, rose by 0.4% relative to a year previously. Adjusted for working days in the month, the volume of retail sales was 0.9% higher in March than in the same month one year earlier. Retail sales, including vehicle sales, rose slightly in the first quarter of 2012 compared with the same three months of the previous year. Real income of households, one of the most important macroeconomic factors determining household consumption growth, fell in the early months of the year, and banks' lending activity continued to be weak. Real net earnings fell in the first quarter despite the administrative wage increases at the beginning of the year. One-off effects make it difficult to interpret recent data. Purchases by non-resident households may have supported retail activity than in previous months following the appreciation of the forint in February. However, purchases in March due to the Easter period in early April may have been a factor pushing up turnover. In summary, the recent data are consistent with the projection in the March issue of the Bank's *Quarterly Report on Inflation*.

Financial market developments

Appetite for risk in international financial markets has fallen significantly since the Monetary Council's interest rate decision in April. Indicators of risk aversion rose sharply, as the VIX index and the EMBI Global returned to levels last seen in early December 2011. Risky assets came under heavy selling pressure as sentiment indicators deteriorated, with demand for some safe haven assets picking up again: yields on ten-year US and German government bonds fell by 20–30 basis points and the EUR/CHF exchange rate fluctuated around 1.2010. At the global level, capital market prices fell by 3%–10% in the month. Commodity prices fell by a similar amount, with the price of North Sea Brent crude oil declining from nearly USD 118 per barrel to USD 108.

Sentiment in international financial markets continued to be fairly weak, driven by developments in the euro area, as in the previous month. Movements in financial markets were influenced by political shocks, particularly the results of elections in France and Greece. The sharp increase in domestic political uncertainty in Greece was identified as the principal factor contributing to the deterioration in market sentiment. The two winning political parties, which are committed to the continuation of the policy of financial austerity, could not agree on forming a coalition government following the May parliamentary elections; it cannot be ruled out that political forces rejecting the stringent fiscal policies, and consequently, the EU-IMF financial package, will win a majority of votes at the repeated elections in June. The situation of near political stalemate in Greece has raised the possibility that Greece may leave the euro area. The risks of a Greek exit from the euro area and potential contagion effects may have been priced in the markets, as reflected in the increase in spreads on bonds of periphery countries and the depreciation of the euro against the US dollar. The outcome of the French elections, in addition to those in Greece, also increased concerns about successful management of the crisis, as the change in presidency in France has led to discordance between France and Germany over issues such as the stability pact and the joint issuance of Eurobonds.

Another source of increased perceptions of risk is the weak capitalisation and toxic assets of Spanish banks, which may lead to a further deterioration in Spain's debt path through the recapitalisation of the banking sector by the state without external assistance and the bail-out of some banks. The critical state of the banking sector and the deteriorating solvency of the sovereign were reflected in the recent credit rating downgrades and rises in indicators of credit risk (bond spreads and CDS premia). Global sentiment was also adversely affected by the outlook for economic activity, as a number of important forward-looking indicators reached critical levels in the euro area. This negative picture was slightly altered by the fact that the majority of first-quarter GDP data were better than expected and the euro area has so far avoided recession, thanks to surprisingly good economic performance in Germany. The recovery of the US economy seems fragile based on macroeconomic data released last month; corporate quarterly earnings results, however, were better than expected.

Hungarian financial market developments reflected two opposing effects in the period. First, there was a strong increase in Hungarian asset prices in response to the press release by the Commission following the meeting between Prime Minister Mr Orbán and the President of the Commission Mr Barroso at the beginning of the period, indicating that negotiations between Hungary and the EU and IMF would start soon. With the strong decline in the country's risk premium, some of Hungary's market indicators rose to the highest levels in several months. The positive effect of this favourable country-specific shock was offset by gradually deteriorating market sentiment over the remainder of the period. As a result, some indicators returned to levels seen at the time of the previous interest rate decision. Weak global risk appetite affected emerging market economies the most, as indicated by withdrawals of capital from the emerging region and increases in bond spreads.

These developments were clearly reflected by the movements in Hungary's risk indicators. The five-year CDS premium fell from 600 basis points to 500 basis points in one week, reflecting the effect of the positive country-specific factor at the beginning of the period. However, after the market priced in the positive news about the negotiations with the EU and IMF, the premium rose once again to near the 600 basis point level, due to the deterioration in the external environment. Foreign currency bond spreads followed a similar path to that of the CDS spread. The spread of the five-year euro bond over German Bunds of equivalent maturity retraced 70 basis points of the 120 basis point fall, with the mid-yield currently standing at 7.6%.

The forint has depreciated by around 1% against the euro since the Council's last policy decision, from EUR/HUF 280–285 (following an initial 5.2%, or HUF 17 appreciation) in the middle of the period to near EUR/HUF 300. Options-based indicators of the market's exchange rate expectations suggested that the forint would remain at the stronger levels it reached following the positive country-specific shock; however, options prices once again began to reflect the market's expectation of an exchange rate depreciation as the forint weakened, driven by global factors. In the FX swap market, spreads rose after falling initially, remaining nearly unchanged at the three-month maturity (160 basis points) and rising by around 55 basis points at the six-month maturity (210 basis points).

In the government securities market, yields on longer-term paper are 20–50 basis points lower than they were at the time of the last interest rate decision, although government bonds are traded at substantially lower prices compared to their levels following the 100 basis point drop in yields in the wake of the meeting between Mr Orbán and Mr Barroso. The auctions of government securities held by the Debt Management Agency were accompanied by healthy, at times strong, demand. The Agency raised the amount on issue at some of the auctions in response to the favourable yield bids submitted.

In terms of the market's interest rate expectations, the picture suggested by FRA rates is similar to that of a month ago: market participants expect the base rate to remain at its current level over the next six months. The interest rate cut of 25 basis points expected by the market, reflected in FRA rates at the 3x6 maturity and beyond, was gradually priced out as market sentiment deteriorated, with rates slightly exceeding the three-month BUBOR in the last few days of the period.

According to the latest Reuters poll, analysts' consensus forecast was for the base rate to remain unchanged at the Monetary Council's next policy meeting. Uncertainty surrounding the agreement between Hungary and the EU and IMF was an important factor influencing longer-term expectations. The majority of analysts expected that an agreement with the multilateral organisations would be reached in the second half of the year, which would allow the Council to start its interest rate reductions. The average of expectations for the base rate (6.72%) at the end of 2012 barely changed relative to the previous survey, while the median expectation rose by 25 basis points to 6.75%. The base rate was expected to be 6.0% at the end of 2013, the same level as in the previous month.

Position of the banking sector

The stock of bank lending to the corporate sector fell slightly further in April, but there continues to be little sign of a turnaround in corporate lending. Average interest rates on loans to the sector barely changed in March. The net monthly change in household lending volumes stabilised as the early repayment programme ended. Net new forint lending was negative, after essentially being positive throughout the period since the onset of the crisis. The drop in the stock of forint loans reflected a sharp decline in gross lending in March. Interest rates on forint home equity loans rose steadily in the first three months of the year.

Based on preliminary data for April, the pause in the outflow of external funds from the seven largest banks proved to be short-lived. Banks financed the shortage of foreign currency liquidity arising from the outflow of funds mainly by reducing their lending activity. The stock of lending to the household and corporate sectors and their exposure to non-residents both fell, which may be related to lower margin calls due to the appreciation of the exchange rate.

The ratio of non-performing loans to the household sector continued to rise in the first quarter. This mainly reflected a decline in the stock of loans due to early repayments; however, restructured loans becoming non-performing again also contributed to the increase in the ratio. The profit-reducing effect of loan loss provisions fell during the quarter, but the indicator remained broadly unchanged excluding the effect of early repayments. The ratio of corporate borrowers in arrears of more than 90 days rose slightly less than expected, while the ratio of loans in arrears of 30–90 days increased sharply. The deteriorating quality of corporate loans continues to place a significant burden on the banking sector, due to the absence of portfolio cleaning. The profit-reducing effect of loan loss provisions remained unchanged after rising sharply at the beginning of the year. The coverage of non-performing loans increased, despite banks setting aside lower provisions for losses. The dispersion among banks fell significantly.

Cumulated within-year profits of the banking sector amounted to HUF 41 billion at the end of March 2012, much lower than the HUF 80 billion profit in the previous year. There continues to be strong heterogeneity in terms of profitability across the sector, with several banks actually recording a loss. The capital adequacy ratio for fell from 13.8% at the end of March 2011 to 13.5% at the end of December 2011, and then rose to 14.3% by the end of the first quarter of 2012. Part of the increase in the first quarter reflected an increase in available capital, while another part reflected a decline in banks' capital requirement (effect of early repayments), due to the falling stock of lending.

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

In the Council's judgement, the near-term prospects for the Hungarian economy were weak, with growth only expected to resume in 2013. The level of output would remain below its potential in the period ahead. Despite subdued domestic demand and the degree of slack in the labour market, the consumer price index was expected to remain elevated over the next few quarters, reflecting the effects of the tax changes and cost shocks. The consumer price index was likely to rise significantly, driven by increases in VAT and excise duties last year and this year, as well as by the depreciation of the forint exchange rate in the second half of 2011 and the rise in oil prices in early 2012. The government measures, announced as part of the Structural Reform Programme, were expected to directly raise inflation in 2013, while causing aggregate demand to contract, thereby reducing the risk of second-round effects on inflation. However, a large majority of members thought that second-round effects could not be ruled out due to persistently above-target inflation, and therefore the Council should closely monitor developments in underlying inflation and earnings.

Members agreed that the significantly weaker-than-expected preliminary first-quarter GDP data may have reflected in part transient factors affecting some sectors of the economy and the faster-than-anticipated weakening in recent economic performance. The sharp deterioration in the external environment worsened the short-term outlook for exports. Although there was uncertainty about the expected recovery in Hungary's export markets from the middle of the year, the pick-up in production following the build-up of manufacturing capacities over the past quarters might boost export growth. Domestic demand, however, was likely to keep falling in the coming quarters. The uncertain prospects for income growth, continued deleveraging by banks, tight credit conditions and the contractionary effects of fiscal measures on aggregate demand continued to point to subdued investment and household consumption in the period ahead.

The majority of members were of the view that it might be necessary to revise down the profile of growth in the light of the latest economic data, both in terms of past performance and the longer-term trends. That might imply a lower growth trend, and the reduction in capacities might result in a faster closing of the output gap. However, some members noted that conclusions about future trends could not be drawn based on a single piece of data.

Members agreed that perceptions of the risks associated with the Hungarian economy had been driven mainly by increasing concerns about the periphery of the euro area and news related to the start of negotiations with the multinational organisations in the past month. Members judged that in the current situation the room for manoeuvre in monetary policy was extremely limited. Therefore, 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. The majority view of members was that such an agreement would have a favourable impact on the outlook for the economy and inflation, in addition to reducing the risks associated with financing government debt. At the same time, several members noted that it would be risky to link monetary easing to the conclusion of the agreement, given that the agreement would not automatically entail a rapid improvement in perceptions about Hungary.

In terms of the assessment of the measures announced by the Government, some members concluded that the latest measures announced as part of the Structural Reform Programme were likely to directly raise inflation both this year and next year. Others, however, noted that the Government's measures directly raising inflation were unlikely to have second-round effects, and therefore they would not raise medium-term expectations.

Council members agreed that developments in risk perceptions and the macroeconomic data becoming available over the past few months as well as the effects of the Structural Reform Programme would be discussed in detail in the June issue of the Bank's *Quarterly Report on Inflation*.

The majority of members were of the view that, given the existing risks and the current economic environment, the room for manoeuvre in monetary policy was extremely limited, and therefore maintaining the base rate was warranted. One member favoured a reduction in interest rates, arguing that their current level was inconsistent with the economy's fundamentals and the budget plans already announced, and, consequently, maintaining interest rates at their current level amounted to a tightening of policy. For that member, it was likely that policy tightening would send the economy into recession, which would add to inflation through spiralling effects rather than reducing it. Another member thought, however, that in the current inflation and financial market environment monetary policy easing would not result in faster growth. Some members judged that it might prove necessary to raise the base rate if risks related to the sustainability of debt in some euro-area countries increased significantly.

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 26 June 2012. The minutes of that meeting will be published at 2 p.m. on 11 July 2012.