MINUTES

OF THE MONETARY COUNCIL MEETING

26 JUNE 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 May, the consumer price index stood at 5.3% and core inflation at 4.8%. Headline inflation fell by 0.4 percentage points and core inflation by 0.3 percentage points relative to the previous month. Lower core inflation mainly reflected the decline in tradables price inflation, while the fall in fuel prices — one of the items excluded form the core inflation measure — had a significant impact on the change in headline inflation. The decline in tradables prices partly resulted from one-off factors, but also reflected the downward pressure of weak demand on price increases. Falling services price inflation also reflected the impact of weak demand. Seasonally adjusted, processed food prices essentially stagnated in May. Within the items excluded from core inflation, the decline in fuel prices in May contributed significantly to the fall in inflation in the month. Measures capturing underlying inflation developments, adjusted for tax changes, suggest a decline in underlying inflation.

Industrial production fell sharply in April. In seasonally adjusted terms, production declined by 4.0% relative to the previous month, with the annual index falling by 4.7% after adjusting for calendar and seasonal effects. Production fell across most of the sub-sectors of manufacturing. However, new orders suggest that the large-scale investment projects implemented in the car industry recently are likely to contribute significantly to the sector's growth in the coming quarters. Exports, which had previously been the driving force behind growth, have been falling continuously since the fourth quarter of 2011. Exports and imports fell broadly similarly in April, and thus the goods balance remained unchanged in the month.

According to the detailed release by the CSO, Hungary's gross domestic product contracted by 0.7% in the first quarter of 2012 relative to the same period of 2011. The detailed release was consistent with the preliminary data and also consistent with signs of a slowdown in general economic activity. Private sector industries producing for the domestic market continued to make little contribution to growth, and value added in sectors producing for export markets fell. On the expenditure side, household consumption fell slightly relative to the fourth quarter of 2011. Household investment declined further, consistent with the negative developments in the housing market. By contrast, large-volume investment projects in the machinery industry continued. Net exports continued to make a positive contribution to GDP growth in the first quarter of 2012, but there was a significant slowdown relative to previous quarters.

According to the CSO release, the volume of whole-economy investment declined by 8.6% in the first quarter of 2012 relative to the same period of the previous year. In part, this sharp decline reflected the completion of a number of major projects at the end of last year. However, the macroeconomic environment continued to make little contribution to a recovery in investment activity in the first three months of the year. Looking ahead, the deteriorating external environment, households' balance sheet adjustment and fiscal adjustment point to persistently low investment.

In April, gross average earnings grew by 2.5% in the total economy: private sector earnings rose by 6.5%, while government sector earnings fell by 7.3% relative to the same period of the previous year. The growth rate of regular pay in both the private and government sectors declined relative to early 2012. Monthly measures capturing underlying movements point to modest earnings growth in the period ahead. Companies continued to cut fringe benefits relative to the previous year.

According to the Labour Force Survey data released by the CSO, the number of employees fell slightly in the total economy. Labour force participation continued to increase. However, the chances of labour market entrants finding a job remain low, due to weak business activity and employment adjustment in the corporate sector. Employment levels fell in the private sector, while the increase in government sector employment reflects the effects of public work programmes. Within the private sector, the fall in employment was concentrated in manufacturing and market services. The unemployment rate continued to be above 11% and there remains a degree of slack in the labour market.

Financial market developments

Appetite for risk in international financial markets has remained broadly unchanged since the Monetary Council's interest rate decision at the end of May. By the end of the period, indicators of risk aversion, such as the VIX, VDAX and EMBI Global as well as safe haven asset prices fell back to levels last seen in the middle of May. The euro appreciated by 0.5% against the US dollar, which was insufficient to offset the 6% decline of the single European currency in May. The EUR/CHF exchange rate remained close to the 1.2000 threshold level. Commodity market prices were sharply lower: the price of crude oil fell by more than 15%, with the price of North Sea Brent crude declining to below USD 90 per barrel.

Sentiment in international financial markets was driven mainly by the events in Greece and Spain during the previous month. The repeated parliamentary elections in Greece were won by parties appearing to be more committed to implementing a fiscal austerity programme, which was received positively by markets. However, the period of calm proved only temporary, due to the initial problems with forming a coalition government and statements about a partial renegotiation of the Greek programme. The subdued market reactions suggest that market participants may have interpreted the outcome of the elections as a reduction in the risk of a Greek exit from the euro in the short term; however, there continues to be great uncertainty about the feasibility of the measures expected from the new government.

The slight reduction in concerns over Greece was mainly offset by the escalation of problems in Spain. Speculation about the size of the Spanish banking sector's recapitalisation needs and the likely approach to implementing it intensified during the month. In mid-June, the Spanish government decided to apply for external assistance and it may receive a EUR 100 billion financial package from the European Union through the central budget, as suggested by preliminary negotiations. Initial market response was favourable, but concerns over the situation increased again. The yield on ten-year Spanish government bonds has been very volatile recently, but overall it rose by only 20 basis points to 6.6%.

Developments in Greece and Spain are likely to continue to drive sentiment in international markets in the period ahead, but in view of weak economic data, the possibility that the US Fed might launch another quantitative easing cycle has increasingly become the focus of market attention.

In the past month, Hungarian financial market developments were driven by both external and domestic factors. The positive country-specific shock is likely to have been related to developments related to the negotiation with the EU and IMF. The forint depreciated from EUR/HUF 299 to 307 in the first few days of the period, before beginning to appreciate gradually, driven by positive global developments, and finally reaching EUR/HUF 287 by the end of the period. Appreciating by some 4%, the forint outperformed other currencies in the region. Non-residents mainly built up short forint positions in the foreign exchange market in the first half of the month, followed by the build-up of long position in the second half. As a result, the sector's speculative positions remained largely unchanged over the period as a whole. The skewness measures of the probability distribution continue to be at high levels, suggesting that there are risks of exchange rate depreciation. The EUR/HUF exchange rate continues to be extremely volatile.

The Hungarian five-year CDS premium fell by 100 basis points, after increasing by 40 basis points, finally declining to around 530 basis points by the end of the period. Comparing movements in the Hungarian CDS premium to those in other premia in region, country-specific factors and global-regional factors equally played a role in the decline. The Hungarian five-year foreign currency bond premium fell significantly, from 750 basis points to 660 basis points, with most of this decline occurring in the final days of the month.

The ten-year government bond yield rose by 50 basis points in the first week of the period, but has since fallen by 100 basis points to 8%. At maturities of up to one year, yields stood at around 7.1% at the end of the month. The auctions of government paper held in the month were mostly successful: although demand for some of the issues was relatively low, the cover ratio for most of them was 2–3. Non-resident holdings of government securities remained broadly unchanged, standing close to their historical peak.

Based on analyses and the latest Reuters poll, market participants expected the base rate to be maintained at 7.00% at the Monetary Council's June policy meeting. Uncertainty surrounding the agreement between Hungary and the EU and IMF continued to be 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. As in the previous survey, the average of expectations for the date of an agreement was October.

Based on FRA rates, the market expects the base rate to remain on hold at the Council's June meeting. FRA rates at the 3x6 maturity shifted lower by 25 basis points, suggesting that the market had priced in a 25 basis point reduction in official interest rate at 3 to 6 months, which might be consistent with the IMF agreement expected for October.

Position of the banking sector

The stock of bank lending to the corporate sector fell further in May, albeit only slightly. In view of the fact that outstanding loans to the corporate sector fell by a total of HUF 120 billion in the first quarter, there continues to be no sign of a recovery in lending to companies. The average interest rate on forint loans to companies of up to EUR 1 million remained broadly unchanged and that on loans of over EUR 1 million rose. The volume of net monthly changes in lending to the household sector stabilised as the early repayment programme ended. Net new forint lending was practically zero in March, with the decline in foreign currency loans accounting for the entire fall in the outstanding stock of lending. Interest rates on forint home equity loans rose steadily in the first three months of the year and continued in April. However, the very low amount of new lending distorts the data. The average interest rate on forint housing loans rose slightly, accompanied by low monthly flow.

Based on preliminary data for May, external funds of the seven largest banks fell at a slower pace relative to the previous month. The decline in foreign currency funding played a dominant role in this fall. Banks had a foreign currency need, due to the withdrawal of external funds and the increasing margin requirement caused by the depreciation of the forint. This was offset by continued deleveraging affecting the private sector and by the increasing stock of swaps. Large banks' outstanding swap contracts increased.

The ratio of non-performing loans to the household sector continued to rise in the first quarter. 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.

The banking sector's cumulated within-year profits before taxation amounted to HUF 90 billion at the end of May 2012, much lower than the HUF 130 billion profit in the same period of the previous year. The capital adequacy ratio rose in April, suggesting that the sector's capital position continued to be very strong. However, there continued to be asymmetries across banks.

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

In the Council's judgement, Hungarian economic output was likely to fall this year, with growth only expected to resume in 2013. The level of output would remain below its potential in the period ahead. The consumer price index was likely to remain above the inflation target for a protracted period, reflecting the effects of tax changes and other administrative measures.

The majority of Council members held broadly similar views to those outlined in the June issue of the *Quarterly Report on Inflation* prepared by Bank staff. Several members judged that, on balance, recent developments in the labour market and investment pointed to a protracted slowdown in potential growth, which could result in lower potential growth in 2013 than in the baseline projection in the June *Report*.

Some members emphasised that there had been a significant deterioration in the inflation outlook relative to the baseline projection in the March *Report*. In the latest projection, inflation was only likely to fall back close the target by the end of 2013, as the Government's measures would lead to a sharp and sustained increase in companies' costs. By contrast, several members noted that inflationary pressures from the real economy continued to be extremely subdued, with the Government's measures as the only factor exerting upward pressure on consumer prices. Some members thought that the longer-term impact of those measures on consumer prices could not be estimated precisely. Other members were of the view that the Government's measures would not have second-round upward effects on prices, due to the existing constraints on demand. One member noted that the price of crude oil, a key factor in terms of domestic inflation developments, had fallen in recent months due to the slowdown in global activity and further declines in oil prices could not be ruled out.

Despite the slight improvement in the past month, perceptions of the risks associated with Hungarian financial assets continued to be negative. Council members agreed that domestic risk premia might fall significantly after an agreement with the multilateral organisations was reached, and 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. 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, while increasing the room for manoeuvre in monetary policy.

In discussing the monetary policy options, the majority of members agreed that maintaining the base rate was warranted this month based on the macroeconomic projection in the *Report*. Some members were of the view that although the sharp decline in demand would justify a cut in interest rates, perceptions about the Hungarian economy continued to be fragile and the economy continued to be affected by upward shocks to the price level, which raised companies' production costs and gradually fed through to core inflation. Several members noted that in the current macroeconomic environment an easing of monetary policy would not be suitable to boost potential growth and would entail increases in stability risks and inflation expectations. Some members judged that the Monetary Council should make efforts to prevent a recession, while others noted that the Monetary Council did not have tools at its disposal which could enable it to boost potential growth and, consequently, the Magyar Nemzeti Bank could best contribute to the success of the Government's stimulatory measures by preserving stability. One member thought that maintaining interest rates at their current level amounted to a tightening of policy and both real economic processes and developments in risk premia already allowed the Council to reduce the base rate.

The majority of members agreed that monetary policy could be eased if the outlook for inflation improved and the risk premium fell steadily and substantially. The timing of that easing would be brought forward by an agreement between the Government and the EU and IMF, which should be concluded as soon as possible.

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

Dávid Gulyás, Head of Division at the Ministry for National Economy, was present as the Government's representative.

The Council will hold its next policy meeting on 24 July 2012. The minutes of that meeting will be published at 2 p.m. on 8 August 2012.