MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

24 JULY 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 June, the consumer price index stood at 5.6% and core inflation at 4.9%. Headline inflation rose by 0.3 percentage points and core inflation by 0.1 percentage point relative to the previous month. The outcome for the consumer price index was higher than projected in the Bank's *Quarterly Report on Inflation* and mainly reflected the impact of one-off factors. Nevertheless, underlying inflation and measures capturing underlying inflation developments, adjusted for tax changes, remained moderate in June, currently standing between 1% and 2%. The pick-up in tradables inflation was the single largest contributor to the increase in core inflation, with the increase in unprocessed food price inflation having the greatest effect among the items excluded from the core measure of inflation. In seasonally adjusted terms, the month-on-month rate of tradables inflation rose in June, with non-durable goods prices rising due to one-off factors and durables prices falling across a wide range of products. Adjusted for seasonal effects, unprocessed food prices rose slightly relative to the previous month. Overall, while inflationary pressures from the real economy have continued to be subdued, reflecting weak domestic demand, inflation has remained above target due to the tax increases in early 2012, the measures included in the Structural Reform Programme and the latest announcement of an increase in excise duties.

Industrial production fell by 0.4% in May relative to the same period of 2011. The performance of industry has been declining since the beginning of the year, despite the sharp month-on-month increase in production in May. Production data for the sector suggest that the large-scale investment projects implemented in the automobile industry may have had an impact in May, but this may have been initially offset by the subdued underlying performance of other sectors. The rate of export growth has been slowing since the fourth quarter of 2011, and industrial sales at home and abroad have stagnated in recent months. The goods surplus rose in May as export growth outpaced import growth. The deterioration in Hungary's terms of trade slowed in April, largely due to the fall in energy prices. Nevertheless, a number of international organisations revised down their expectations for global growth in their July forecasts. Consistent with this, there is significant uncertainty around the recovery in Hungary's export markets expected from the second half of this year, and domestic exports and industrial production may be hampered by a further slowdown in external demand.

The volume of construction output was 15.2% lower in May than a year earlier, both in unadjusted terms and adjusted for working days. In aggregate, output fell by 10.8% in the first five months of the year relative to the same period of 2011.

Adjusted for working days, the volume of retail sales fell by 2.7% in April relative to a year earlier. Total sales (which also include sales of vehicles and components), exhibiting a closer correlation with consumption expenditure, were 1.4% lower than in the same period of the previous year. Real earnings, one of the most important macroeconomic factors determining household consumption growth, fell in the early months of the year, and continued weak lending activity by banks also continued to be a constraint on consumption spending. Overall, underlying developments in retail sales point to a further decline, and consequently household consumption expenditure is expected to fall further after stagnating in the first quarter of the year.

According to the Labour Force Survey data released by the CSO in May, the numbers of persons employed and unemployed in the total economy rose by 2.0% and 2.6% respectively relative to the previous year. Public work programmes may have contributed to the increase in the number of employees. The unemployment rate remained above 11%.

In May, whole-economy gross average earnings rose by 6.4%: private sector earnings rose by 9.4%, while government sector earnings (including those of public workers) fell by 0.6% relative to the same period of the previous year. Private sector earnings growth returned to the high levels recorded at the beginning of the year. The sharp increase may have been driven in part by various composition effects and specific wage-setting in a number of industries. Underlying economic activity is inconsistent with this high rate of wage growth, and this may mean that firms are continuing to cut back irregular pay. Overall, it is currently difficult to judge the extent to which the May pick-up in wage growth reflected an improvement in activity. Nevertheless, the latest data represent an upside risk to the Bank's projection for wage growth in 2012.

Financial market developments

International financial market developments were fairly mixed in the period between the Monetary Council's interest rate decisions in June and July. Overall, global risk aversion fell. The EU summit at the end of June caused a spectacular improvement in sentiment in international markets. In response to the deterioration in the growth outlook, several major central banks (ECB, BoE, PBOC) eased monetary policy, which also contributed to the improvement in global sentiment. Following the EU summit, investors once again turned their focus to the deteriorating growth outlook, in part due to the weak economic data released during the period and the downward revisions by several large organisations (e.g. OECD, IMF) to their growth forecasts. Markets are still concerned by the situation of the Spanish banking sector; a final decision has not yet been made on the bank consolidation package. The USD/EUR exchange rate fell by nearly 2% in the period, possibly indicating the uncertainty around the EU crisis management regime.

As a result of these factors, risky asset prices rose on balance. The main US equity indices were up by 1.5%–2.5% and those in Europe by 4%–7%, with gains in Asian markets ranging somewhat more widely between 1%–6%. The declines in the major risk aversion indicators also confirm the increase in investor risk appetite. Sovereign bond spreads in euro-area periphery countries fell during the period. Yields in the secondary markets declined and auction results were positive. Increased demand for premium assets is illustrated well by the fact that 1–2 year yields on other highly rated euro-area securities fell into negative territory, in addition to those on German sovereign bonds.

Hungarian financial market developments were driven by the overall improvement in global markets, as well as by expectations about the length and ease of negotiations with the EU and IMF. Based on the statements made before the start of negotiations, analysts expect a protracted process marked by occasional conflicts. In addition to the loan negotiations, analysts also paid attention to the likely timing of policy easing by the Monetary Council, made possible by the fall in Hungary's risk premium. In this context, market analysts pointed out that members gave contradictory messages about the timing of an interest rate reduction, which indicated a division of views on the issue within the Council. Hungary's market indicators improved overall, but some assets reacted less strongly to positive global shocks than would have been justified by the country's sensitivity to shocks.

Hungary's five-year CDS premium declined by some 40 basis points to around 480 basis points. This fall was somewhat larger compared to the averages of Central and Eastern Europe and the CEEMEA region covering a wider geographical area. However, the value of the percentage change was lower than the regional average, suggesting that the fall in the premium in response to the positive global environment was smaller than would have been justified by Hungary's beta.

The EUR/HUF exchange rate was at about the same level at the time of the July interest rate decision as it was a month earlier. The Polish zloty and the Czech koruna both appreciated by 2% in the period. The exchange rate effect of bond purchases by non-residents in the wake of an increase in expectations of an interest rate cut in Poland played a key role in the appreciation of the zloty.

In the FX swap market, liquidity strains arose from balance sheet optimisation by some market participants at the end of the quarter, leading to a temporary sharp decline of some 300–350 basis points in forint short-term implied yields. After the balance sheet date, spreads normalised and non-resident holdings of two-week MNB bills, which had been reduced earlier, rose back to previous levels.

Government securities yields at maturities of more than three years declined significantly, by 80–85 basis points. Yields at maturities of one to three years fell by 40–60 basis points and Treasury bill yields edged down by 15–20 basis points. The decline in yields largely coincided with the spectacular improvement in global market sentiment. Within the CEE region, Hungarian yields fell the most sharply, while yields on Czech government securities fell by nearly the same amounts as Hungarian yields at some maturities. These positive developments were also reflected in the securities auctions conducted during the month, with the Government Debt Management Agency able to raise the amounts on offer at several auctions due to very strong demand. Auction yields fell.

Sixteen of the 20 economists polled by Reuters in July expected the Monetary Council to leave the central bank base rate unchanged at 7.00% at its July meeting. Four analysts, however, expected a 25 basis point reduction, which suggested that the consensus of market analysts fell slightly relative to the uniform expectations in May and June that the base rate would remain on hold at 7.00%. 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 final quarter of the year, which would allow the Council to start its interest rate reductions.

Market participants' interest rate expectations fell in July. Based on FRA rates, the market expects the base rate to be maintained at the Council's July meeting. The base rate is expected to remain unchanged at the Council's August meeting, but the market sees a greater likelihood of a 25 basis point reduction in September. Although the trend of rates started to decline earlier, statements by Monetary Council members may also have had an impact on the increase in interest rate expectations.

Position of the banking sector

The stock of domestic bank lending to the corporate sector fell more strongly in June compared to the previous month. Outstanding forint and foreign currency lending both declined. This drop in the stock of lending reflected the maturity profile of loans: more longer-term loans tend to expire in June than in other months of the year. In May, the average interest rate on forint corporate loans of up to EUR 1 million remained broadly unchanged and that on loans of over EUR 1 million fell slightly.

The household market showed a broadly similar picture to that of the previous months: bank lending to households continued to decline in June, reflecting a modest drop in forint lending and a sharp decline in foreign currency lending. New lending to the sector continued to be weak, remaining at very depressed levels since the end of the early repayment programme. In May, the average interest rate on forint housing loans and home equity loans fell slightly.

Based on preliminary data for June, external funds of the seven largest Hungarian banks rose slightly relative to the previous month. Forint and foreign currency funds contributed equally to the increase in external funds. In addition to the modest inflow of funding, outstanding swap contracts of the seven largest banks fell significantly. This reflected the appreciation of the forint and the related decline in margin requirements. In addition, the foreign currency position of the largest banks vis-à-vis the private sector has improved significantly in recent months, largely as a result of the decline in outstanding foreign currency lending and the increase in foreign currency deposits.

Based on the available data for May, external funds of the domestic banking sector fell. Outflows of external funds from the sector in the first five months of the year continued to be consistent with the updated baseline projection in the Bank's *Report on Financial Stability*.

The banking sector's cumulated within-year profits before taxation amounted to HUF 60 billion at the end of June 2012, which is much lower than in the same period of the previous year. Profitability continued to be highly concentrated among banks. The overall capital adequacy ratio changed little: the domestic banking sector's average capital position continued to be strong. However, there were significant asymmetries across individual 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 an extended period, reflecting the effects of tax changes and other administrative measures.

A large majority of Council members noted that inflation developments continued to reflect divergent effects. Inflationary pressures from the real economy remained subdued, but the tax increases in early 2012, the measures included in the updated version of the Structural Reform Programme and the announcement of an increase in excise duties at the end of June for next year were likely to cause inflation to exceed the target over a sustained period. Although weak demand and the slack labour market offset the inflationary impact of the fiscal measures, inflation was likely to remain above target not only in 2012, but also in 2013, and consequently the target was only likely to be met in 2014. Some members noted that underlying inflation developments were favourable, expectations could not be detected and tax-adjusted core inflation was expected to remain below the Bank's inflation target over the entire forecast period. By contrast, others pointed out that the Magyar Nemzeti Bank's inflation target was linked to movements in the consumer price index. Other members noted the sharp deceleration in potential growth, the faster closing of the output gap and the persistence of inflation expectations.

Council members agreed that Hungary's GDP was likely to rise modestly in 2013 following this year's drop in output. The level of output was expected to remain below potential on the forecast horizon, and accordingly the unemployment rate would remain stuck at a high level over a longer period, pointing to a loose labour market. Exports would remain the main engine of growth, although export growth would slow significantly in 2012, consistent with the outlook for Hungary's major export markets. The outlook for domestic consumption would deteriorate further, reflecting the effects of falling household real income, tight credit conditions due to deleveraging by banks and the fiscal adjustment measures.

Hungarian risk premia had fallen during the month prior to the Council's policy decision in July, prompted in part by the ECB's interest rate cut and the pick-up in capital inflows to emerging markets as a result of the low external interest rate environment in the wake of the ECB's move. In addition, expectations about the negotiations with the multilateral organisations had also exerted downward pressure on premia. Nevertheless, several members judged that global factors had been the largest contributor to the fall in risk premia, which might remain volatile. Some members noted that Hungary's risk indicators remained at high levels compared to other countries of the region. Other members judged that there had been a significant improvement in the risk perception of Hungary, which might be expected to continue.

The majority of Council members felt that the high debt-to-GDP ratio and the relatively high levels of external debt made the Hungarian economy susceptible to external shocks. The

Monetary Council therefore 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 achieve a sustained reduction in the risks associated with financing government debt.

In discussing the monetary policy options, the majority of members noted that the strength of the opposing factors influencing monetary policy had increased during the month preceding the interest rate decision. The less favourable data on inflation and earnings than assumed in the baseline projection in the June *Report* supported policy tightening, while the unfavourable growth data supported policy easing. Other members, however, suggested that underlying inflation developments were favourable and that the unfavourable earnings data did not pose upside risks to inflation, due to the slack labour market.

Views differed on recent developments in perceptions of the risks associated with the economy, in addition to inflation developments. The majority of members concluded that perceptions about the Hungarian economy had not yet improved significantly, and therefore they favoured maintaining interest rates. By contrast, other members noted that underlying inflation continued to be moderate and Hungary's risk indicators had started to converge towards regional levels, after having fallen in July.

The Council was divided over whether policy easing would be appropriate to boost economic output. Some members noted that premature policy easing would not boost potential economic output, in addition to having an adverse impact on inflation developments and risk perceptions. By contrast, others stressed that the current level of the central bank base rate placed a significant burden on the real economy.

One member judged that the 25 basis point reduction in interest rates supported by the member would not represent a significant easing of policy, in view of the fact that the European Central Bank had already reduced the interest rate on its main policy instrument by the same amount in July. That member concluded that in the circumstances maintaining interest rates at their current level amounted to a tightening of policy.

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% and two members 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, Júlia Király, András Simor
In favour of reducing the base rate to 6.75%	**2**	János Cinkotai, György Kocziszky,

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

The Council will hold its next policy meeting on 28 August 2012. The minutes of that meeting will be published at 2 p.m. on 12 September 2012.