MINUTES
OF THE MONETARY COUNCIL MEETING
28 AUGUST 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 July, the consumer price index stood at 5.8% and core inflation at 5.1%. Both headline inflation and core inflation rose by 0.2 percentage points relative to the previous month. The consumer price index and core inflation figures were both higher than the projection and the market's expectation. On the other hand, demand-pull inflationary pressures remained subdued and the Bank's alternative measures tracking trend inflation fell during July. The higher-than-expected outcomes for inflation reflected a number of factors. Indirect tax increases and rises in processed food prices were the largest contributors to the acceleration in core inflation. Furthermore, the rise in tradables prices in June – largely driven by one-off factors – continued to hold annual inflation above the expected levels, even though it did not contribute to the monthly rate of inflation. Higher inflation of items excluded from the core measure of inflation mainly reflected the sharp rise in unprocessed food prices. Overall, while inflationary pressures from the real economy continue to be subdued due to weak domestic demand, the latest data, the higher-than-anticipated price of crude oil and the unfolding food price shock pose upside risks to inflation. However, the strength of the forint may cushion some of these effects.

The Hungarian economic downturn continued in the second quarter of 2012. According to the preliminary release by the CSO, Hungary's gross domestic product contracted by 1.2% relative to the same period of the previous year. GDP declined for the second successive quarter in Q2, meaning that the domestic economy has technically entered a recession. Based on the preliminary data, the Bank has revised down its projection for the real economy.

The decline in industrial production since the beginning of the year has continued, as output fell by 0.6% relative to June 2011 and by 0.2% relative to May. Automotive industry output has picked up strongly since early 2012. By contrast, performance in a number of sub-sectors within manufacturing has stagnated or fallen. The decline in the rate of export growth since the final quarter of 2011 has continued and the volume of industrial sales has remained modest. Hungary's goods surplus rose in June, owing to a larger decline in imports than in exports. The terms of trade continued to deteriorate in May, mainly reflecting rises in energy prices. Overall, the latest data point to a weak outlook for domestic and external economic activity, which in turn may continue to hamper domestic exports and industrial production.

In June, the volume of construction output was down 11.2% on a year earlier, both in unadjusted terms and adjusted for working days. In aggregate, output of the sector fell by 10.1% in the first six months of the year relative to the same period of 2011.

Adjusted for working days, the volume of retail sales fell by 2.5% in May relative to a year earlier. Total sales (which also include sales of vehicles and components), exhibiting a closer correlation with consumption expenditure, were 1.8% lower than in the same period of the previous year. Real earnings, one of the most important macroeconomic factors determining household consumption, fell further in a year-on-year comparison, 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 household consumption expenditure is consequently expected to fall further, after stagnating in the first quarter of the year.

In June, whole-economy gross average earnings rose by 4.1%. Private sector earnings rose by 7.3%, while government sector earnings (including those of public workers) fell by 3.1% relative to a year earlier. The sharp increase in earnings experienced in earlier months stopped and the upward spike in May appears to have been reversed. Reflecting falling net demand and accelerating inflation, real earnings in the private sector edged down by 1.2% after rising by 1.1% in May, bringing the average decline in real earnings in the first six months of the year to 3.7%. The number of persons employed in the total economy fell: employment declined both in the private sector and the government sector, excluding public workers. The unemployment rate was higher in the second quarter than a year before, remaining at elevated levels (10.9%).

Financial market developments

Developments related to crisis management efforts within the euro area were the most important factor influencing global market events following the Monetary Council's July interest rate decision. Due to the existing problems and debates over the practical implementation of crisis management measures, risk aversion and negative investor sentiment were evident in the markets in early July, reflecting the financing problems of the Spanish banking system and general government. Subsequently, statements by senior ECB officials at the end of July and speculation over the decisions of the European Central Bank in early August led to a turnaround in market sentiment. Trading calmed down from the second week of August and indicators moved sideways, with only the release of a couple of macroeconomic data influencing movements in markets. In the US, a number of important economic indicators (e.g. employment, manufacturing PMI, retail sales) turned out to be higher than expected. In Europe, by contrast, data suggesting a weak outlook for activity were released during the period.

Owing to the recovery in investor risk appetite, global financial market indicators improved significantly, with a number of market indices rising close to highs for this year. Leading stock exchange indices rose above the year's opening levels by 5%–9%, and key risk indicators fell. The euro appreciated by 4% against the dollar, buoyed by hopes related to euro-area crisis management. German and US long-term bond yields rose by 20–30 basis points, while yields in the periphery countries of the euro area fell significantly. The price of North Sea Brent rose by 12%, due in part to the improvement in global sentiment and the escalation of geopolitical tensions.

Hungarian financial market developments were driven mainly by the overall improvement in the global environment. Country-specific factors did not materially influence domestic developments, apart from the positive impact of statements about the IMF negotiations by government officials on perceptions about Hungary at the beginning of the period. Movements in domestic asset prices and the forint exchange rate remained broadly unaffected by the release of macroeconomic data and news related to the amendment of next year's government budget bill. Hungary's market indicators clearly improved, but liquidity in most sub-markets was low and investors took a wait-and-see attitude, particularly from the second week of August.

Hungary's CDS premium has continued to fall since the Council's July interest rate decision, with the five-year spread declining by 80 basis points to below 430 basis points. That reflected almost exclusively international developments, as movements in the premium have not been influenced by country-specific factors over the past month. The EUR/HUF exchange rate strengthened significantly: the forint appreciated by 4%-5%, moving to below 275. Despite the slight correction at the end of the period, the forint remained strong versus the euro, at levels last seen a year earlier. With this strengthening, the forint was the best performing currency in the region: the Polish zloty and the Romanian leu appreciated by 3% and the Czech koruna by 2.5% in the period.

In the domestic FX swap market, trading was much quieter than during the period of market tensions seen at the end of the second quarter. Overnight and three and six-month premia fluctuated in a narrow band, with a further slight narrowing towards the end of the period. Non-residents' net outstanding swaps fell.

Hungarian government securities yields rose significantly during the days around the Council's July policy decision, before falling in August. Three and five-year benchmark yields experienced the largest fall, as yields again dropped to below 7% in this segment of the yield curve, after falling by 40–50 basis points. At the longer end of the curve, i.e. at 10 out to 15 years, yields fell by some 25 basis points. By contrast, the short end of the yield curve remained unchanged. Demand was adequate and yields moved narrowly at the majority of the government securities auctions held in the month.

The majority (16) of the total of 19 economists polled by Reuters in August expected the Monetary Council to leave the central bank base rate unchanged at 7.00% at its meeting in the month. Based on market prices, interest rate expectations continued to fall in the period. FRA rates suggest that a slight majority of market economists expect the base rate to be maintained at the August policy meeting. By contrast, a 25 basis point reduction is clearly expected at the September meeting, and another 25 basis point cut at the October meeting.

Position of the banking sector

The stock of domestic bank lending to the corporate sector continued to fall in June relative to previous months. Although outstanding forint lending increased, this was offset by a decline in the stock of foreign currency loans. In July, the average interest rate on small-value forint corporate loans remained broadly unchanged and that on larger-value loans rose slightly.

The household market showed a broadly similar picture to that of previous months: bank lending to households continued to decline in July, reflecting an increase in forint lending and a decline in foreign currency lending. New lending to the sector has been weak since the end of the early repayment programme. In May, average interest rates on forint housing loans and home equity loans changed little.

Based on preliminary data for July, the external funding of the seven largest Hungarian banks fell slightly further. Outstanding swaps rose by less than the outflow of external foreign currency funds, as banks continued to deleverage by reducing their lending to the private sector. At the end of July, net outstanding swap contracts of the seven largest banks were significantly below their historical peak, but remained high. According to data for the entire banking sector for June, external liabilities increased significantly.

The ratio of non-performing loans to total household loans increased further in the second quarter. That increase was stronger than the Bank anticipated, caused in part by slower-than-expected progress with the government programmes and the decline in renegotiated loans. The profit-reducing effect of loan loss provisions moderated in the course of the quarter: it remained broadly unchanged, excluding the effects of the early repayment scheme. Within corporate loans, the ratio of borrowers in arrears of more than 90 days rose further, while that of borrowers in arrears of 30–90 days fell. The deteriorating quality of corporate loans continues to place a significant burden on the banking sector, due to the lack of portfolio cleaning. The profit-reducing effect of loan loss provisions fell by the end of June.

The banking sector's cumulated within-year profits before taxation amounted to HUF 22 billion at the end of July 2012, which was much lower than in the same period of the previous year. Profitability continued to be highly concentrated among banks. The overall capital adequacy ratio rose slightly, suggesting that the domestic banking sector's average capital position continued to be strong, but 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 over the policy horizon, reflecting the effects of tax changes, administrative measures and rising commodity prices.

Members agreed that CPI inflation in June and July had been higher than previously expected, as a result of higher unprocessed food prices and the increase in excise duties in the course of the year. Several members noted that the fiscal adjustment measures expected during the latter part of the year, the higher-than-expected global oil prices and the unfolding food price shock represented additional upside risks to inflation. The latter had been reflected in developments in unprocessed food prices in recent months. The consumer price index was also expected to remain significantly above the medium-term target in 2013, due to a series of increases in indirect taxes affecting consumer prices. Some members thought that despite the correction in June, the extent of the pick-up in wage growth posed an upside risk to inflation. Others, in turn, noted that the wage data for July did not represent significant upside risks to inflation, due to the slack conditions in the labour market. Some members were of the view that core inflation developments and the increase in production costs added to inflation risks, while others argued that significant second-round effects could not be expected, due to the persistent weakness in domestic demand. One member noted that in terms of overhead costs, the authorities raised prices very modestly, in proportion to rises in actual costs, in contrast with the sharp increases in the previous period, which had a benign impact on developments in the consumer price index.

Members agreed that the Q2 GDP data reflected a weakening in general economic activity, with the contraction in output during the quarter implying that the economy was technically in recession. The level of output would remain below its potential this year and next. Domestic demand was likely to fall further in the coming quarters. Members' views were divided over the likely causes of the recession. Some members thought that tight lending conditions, in addition to the deteriorating outlook for external activity, was the main factor constraining the economy's growth prospects. Others, in contrast, pointed out that beyond the weak economic outlook, the unpredictability of the business environment and economic regulations were also acting as a brake on activity.

Members agreed that there had been a sustained improvement in perceptions about the Hungarian economy. However, some members noted that the improvement had been driven mostly by external factors, and announcements related to euro-area crisis management as well as expectations related to the planned measures helped sustain positive international investor sentiment. Decision and implementation risks associated with measures designed to address problems related to sovereign debt sustainability within the euro area over the longer term remained high, and an improvement in positions in the euro area might contribute to a reduction in perceptions of the risks associated with Hungary. Members agreed that it was crucial in terms of the future evolution of the risk premium that the Government remained committed to maintaining a sound fiscal policy and to reaching an agreement with the European Union and the International Monetary Fund.

In discussing the monetary policy options, some members noted that due to the higher outcome for inflation relative to the projection in the June *Report* and upside risks, it was not appropriate to reduce the base rate this month. One member pointed out that the macroeconomic data received since the latest *Report* might alter the picture of inflation developments to an extent which the Magyar Nemzeti Bank would only be able to quantify at the time of preparing the next *Report*. Several members noted that the expected government measures to reduce debt were still unknown and, consequently, their impact on the consumer price index could not be estimated at the time of the August policy decision.

Members' views were divided over whether monetary policy would help increase economic output. Members agreed that the current level of the central bank base rate placed a significant burden on the real economy. One member noted that the ECB had twice reduced interest rates recently and, consequently, maintaining interest rates at their current level would amount to an undue tightening of policy, while Hungary's risk premium had fallen in the past three months. The majority view of the Council was that it was time to act in the interests of growth. By contrast, some members judged that premature policy easing would not have a material impact on economic output due to other factors restraining economic growth and the recovery in lending, while it would adversely affect inflation developments and perceptions of the risks associated with the Hungarian economy.

Some members noted that a reduction in interest rates was not consistent with the Council's press releases explaining the Council's policy decisions issued since the June *Report*, with particular regard to the developments in inflation and the economy that had taken place since then.

After the discussion, the Chairman invited members to vote on the proposals put to the Council. Four members voted to reduce the Bank's policy rate to 6.75% and three members voted to maintain it.

In the Council's judgement, monetary policy could only be eased to the extent that supply shocks to the economy and the upward impact on prices of the Government's measures did not lead to the build-up of second-round inflationary effects and perceptions about the Hungarian economy continued to improve.

Votes cast by individual members of the Council

In favour of reducing the base rate to 6.75%	**4**	Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, György Kocziszky
In favour of maintaining the base rate at 7.00%	**3**	Ferenc Karvalits, Júlia Király, András Simor

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 25 September 2012. The minutes of that meeting will be published at 2 p.m. on 10 October 2012.