MAGYAR NEMZETI BANK

MINUTES
OF THE MONETARY COUNCIL MEETING
25 SEPTEMBER 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

Hungarian economic activity has deteriorated and inflation has risen recently, reflecting both external and domestic factors. Despite weakening demand, inflation data were higher than expected. Weak economic growth and high inflation may persist for most of the forecast period. Due to the Government's measures aimed at achieving the fiscal targets and the effects of the cost shocks unfolding over the past quarter, inflation is likely to remain steadily above the target next year, before falling back to 3% in the second half of 2014.

The Hungarian economy entered into recession in early 2012, and growth is only expected to be modest next year as well. This weak economic performance partly reflects the slowdown in global economic activity and the effects of domestic factors. External demand is expected to pick up from the end of the year, but is likely to grow only modestly in the coming years, due to the protracted crisis management efforts in the developed economies. Nevertheless, exports are expected to remain the main driving force behind Hungarian economic growth. Domestic demand will probably remain subdued, reflecting a prolonged period of balance sheet adjustment by economic agents in Hungary. This impact may be amplified by the fact that the supply of credit remains weak and bank lending conditions may remain tight for some time to come. Household real income is expected to fall substantially this year, the effects of which will be reflected in a prolonged decline in consumption. Corporate investment activity remains subdued, in part owing to the uncertain demand outlook and the risks associated with the regulatory environment. With this prolonged weakness in investment activity, the potential growth rate of the Hungarian economy may have declined further this year, and little improvement is expected in this regard in the coming years. According to the current projection, output remains below its potential level over the entire forecast period.

Corporate labour demand may remain persistently low, reflecting weak economic activity and unfavourable future income prospects. The Government's job protection action programme is primarily aimed at maintaining existing jobs, and therefore private sector employment is likely to increase only modestly in 2013 after declining slightly this year. Unemployment is expected to remain high, due in part to structural factors, and consequently the downward pressure on wages from the loose labour market environment may ease. Nominal earnings growth has accelerated sharply this year, due to administrative measures. Recent high earnings growth and deteriorating economic activity have led to further rises in unit labour costs. The Government's actions to compensate companies may offset the increase in corporate labour costs in the short term, but high unit labour costs may generate upward pressure on inflation over the longer term, particularly in labour-intensive sectors.

Inflation has been higher than expected in recent months. The acceleration in inflation mainly reflected the second-round effects from rises in commodity prices, but underlying inflation, adjusted for the effects of costs shocks, also increased, despite weak demand. Core inflation remains stuck at early 2012 levels, implying that the downward effect of anaemic demand may have weakened somewhat. Global commodity prices have risen sharply in recent months, despite the deteriorating growth outlook. Upward pressure on agricultural product prices has been particularly strong, due to the poor harvest results at the global level. Increases in commodity prices are likely to initially feed through into the prices of items excluded from core inflation, and then gradually into core inflation as well. With a negative output gap, there are unlikely to be strong second-round effects over the entire forecast period. Inflation is expected to remain well above 3% for most of the forecast period, and is only likely to return to close to the target in the second half of 2014.

The decline in the risk premia on Hungarian financial assets in recent months has increased the room for manoeuvre in monetary policy. In the baseline projection, the deterioration in the inflation outlook results in a tightening of monetary conditions while the weak demand causes easing. These effects offset one another in the first part of the forecast period. Consequently, the baseline inflation projection is consistent with maintaining interest rates at their August level.

Financial market developments

Conditions in the domestic financial market were characterised by two trends in the period between the Monetary Council's policy decisions in August and September. On the one hand, international investor sentiment continued to improve, which had a favourable impact on Hungarian indicators. On the other hand, however, country-specific factors contributed to an increase in risk premia on domestic assets. In most of the Hungarian markets, the first of these two effects was stronger, resulting in an overall improvement in Hungary's indicators.

Market participants viewed the ECB's bond purchase programme as significantly reducing the likelihood of 'disaster' scenarios. Germany's Federal Constitutional Court cleared the way for the European Stability Mechanism on 12 September, while making the increase in German funds subject to parliamentary approval, thereby also contributing to an increase in appetite for risk. At its meeting in September, the US Federal Reserve Board announced that it would launch the third round of quantitative easing (QE3). The most surprising aspect of the announcement was that the Fed did not set a time limit for the new programme. In the wake of the central bank measures viewed as having a positive impact in terms of crisis management, global financial market indicators strengthened further after rising in August. Favourable global sentiment increased the attractiveness of emerging regions, which had already been highly attractive due to the low level of returns globally. The capital markets in Central and Eastern Europe benefited particularly from the benign external environment.

Country-specific perceptions of the risks associated with the Hungarian economy were influenced mainly by the expected course of the negotiations with the IMF and the related announcements and statements, although the August interest rate decision also had an impact on the market. In the Government's communication, statements related to the IMF conditions and the draft of the 2013 Budget Bill, as well as announcements related to the time schedule of negotiations contributed to heightened uncertainty about a possible agreement.

In the early part of the period since the Monetary Council's August policy meeting, the forint depreciated by 1.5% against the euro following the surprise interest rate decision by the MNB and by another 1% in response to news of the deteriorating economic outlook in Poland. Daily movements in the exchange rate were mainly influenced by global events, but announcements related to the negotiations with the IMF also played a role. In terms of Hungary's risk indicators, the domestic CDS spread continued to fall following the August interest rate decision, with the five-year spread moving back into a range of 370–380 basis points, clearly reflecting global developments.

Movements in yields in the secondary market for government securities largely followed changes in risk perceptions. Benchmark yields fell by 10–25 basis points at most maturities, reflecting the improvement in global sentiment. Demand at most of the auctions was adequate, with auction yields falling moderately over the period. Non-residents' government securities holdings reached a new record high, rising near to HUF 4,800 billion in the middle of September. The sector's MNB bill holdings fell by HUF 210 billion.

The majority of analysts expected the base rate to be maintained at 6.75% at the Monetary Council's September meeting, with most of them anticipating a reduction during the fourth quarter. Interest rate expectations for the end of the year were spread between 6.00% and 6.75%. Two-thirds of analysts expected the MNB's policy rate to be 6.50% at the end of the year. The consensus forecast for the end of 2013 is around 6.00%.

Following the August interest rate decision, FRA rates fell at the shortest maturities, but rose slightly at longer maturities. The FRA curve continues to imply a downward path for interest rates. FRA rates for September were consistent with interest rates remaining steady at the current levels; the next 25 basis point reduction is expected to take place in October. Based on the curve, the trough of the interest rate cycle may be at a level of 5.75%–6.00% for the base rate.

Position of the banking sector

In July, the stock of domestic bank lending to the corporate sector fell by largely the same amount as in the previous month. Forint and foreign currency loans both declined, with a decrease in outstanding lending at the majority of large domestic banks, with one exception. The average interest rate on forint corporate loans remained broadly unchanged in July.

Compared to the previous six months, the stock of household loans fell slightly more strongly in August. This may have reflected conversions of non-performing foreign currency loans into forint-denominated loans with partial cancellation. The change in the stock of loans resulted from an increase in forint lending and a decline in foreign currency lending. New bank lending to households continued to be low.

Based on preliminary data for August, outflows of external funds accelerated again, following a slowdown up to July. Foreign currency funds accounted for two-thirds of the outflow of funds. Despite the withdrawal of external funds, net outstanding swaps of the banking sector have been falling steadily since the beginning of the year.

At the end of August, the banking sector's cumulated within-year profits before taxation fell sharply relative to the same period of the previous year (pre-tax profits amounted to HUF 230 billion a year ago). Profitability continued to be highly concentrated among banks. The sector's overall capital adequacy ratio rose slightly and significantly exceeded the minimum regulatory level.

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

At its September policy meeting, the Monetary Council judged that the annual consumer price index might remain persistently above the target. The majority of members thought that inflation would remain elevated, caused by the increases in indirect taxes and the ongoing cost shocks. Some members concluded that Hungary's poor real economic performance mainly reflected cyclical factors, and the disinflationary impact of subdued domestic demand and the loose labour market would materialise sooner or later. One member noted that the risk of second-round effects was low. Others, however, pointed out that the measures of underlying inflation, adjusted for one-off effects, had also risen, and therefore the feed-though of the cost shocks into prices might be greater than previously expected. Another member noted that lacklustre real economic performance could basically be attributed to the euro-area crisis. It was also argued that weak economic performance might reflect mainly structural factors, and as a result the disinflationary impact of subdued demand was smaller than expected. Several members noted that, according to the baseline projection in the September *Quarterly Report on Inflation*, the target would be met by the second half of 2014, assuming that the base rate remained constant at its August level over a sustained period.

Monetary Council members agreed that there had been a deterioration in the outlook for economic growth, with output expected to grow only slowly next year, following the decline in 2012. The potential rate of economic growth would remain low, reflecting persistently high unemployment and subdued investment. Domestic demand was likely to remain weak for some time, due to falling real incomes, continued balance sheet adjustment, generally tight credit conditions and the uncertain economic environment. Exports, which had slowed significantly this year and were expected to grow at a slow pace next year, would remain the main driving force behind growth. However, there was a range of views among Council members over the extent to which the decline in economic growth reflected structural or cyclical factors.

The Monetary Council judged that there had recently been a significant improvement in perceptions of the risks associated with the Hungarian economy. However, some members noted that the decline in domestic risk premia had been caused by international events, while country-specific risk premia had risen slightly in the past month. Members considered it crucial that an agreement between the Government, and the European Union and the International Monetary Fund was reached as soon as possible in order to further reduce the risks associated with financing the government debt and achieve a reduction in risk premia.

In addition to the baseline projection in the *Quarterly Report on Inflation* prepared by Magyar Nemzeti Bank staff in September, the Monetary Council considered two alternative risk scenarios to be relevant. In the first scenario, members expected higher potential output, a worse cyclical position and a stronger disinflationary impact than in the baseline projection. This scenario assumes that the crisis may have eroded potential output to a lesser extent and that structural unemployment may be lower than in the baseline projection. If these assumptions held, then the cyclical position of the economy was weaker and the disinflationary impact stronger, and therefore inflation would fall as the direct effects of the cost shocks faded. The majority of Council members judged that in this risk scenario the inflation target could be met by maintaining looser monetary conditions. The second risk scenario assumes that expectations may have become less well anchored due to high inflation in past years. This was suggested by the increase in underlying inflation in recent months, which might be explained by the fact that economic agents' inflation expectations may have increased, due to the protracted period of above-target inflation and the continuing cost shocks to the economy. In that case, the likelihood of so-called second-round inflationary effects of the cost shocks, working through expectations, was greater. Compared to the baseline projection, this risk scenario required a more restrictive monetary policy, i.e. monetary policy tightening.

In discussing the monetary policy options, the majority of members thought that there continued to be a significant margin of spare capacity in the economy, despite the slowdown in potential growth. For that reason, weak demand provided a significant cushion against the inflationary impact of cost shocks, and therefore those members thought that the inflation target would be met as the direct effects of the cost shocks waned. By contrast, other members were of the view that an easing of monetary conditions would not be capable of providing a boost to the real economy, due to the existing structural problems. Another argument was that the increase in indirect taxes, considered as having a temporary effect, and rises in food prices all over Europe accounted for a significant part of the pick-up in inflation, which monetary policy had no tools available to eliminate.

The majority of Council members judged that the measures to address the European debt crisis had contributed significantly to the improvement in the global financial market environment, which had also led to a sustained fall in premia on domestic financial asset prices. Several members noted that there had been a material improvement in perceptions of the risks associated with the Hungarian economy in recent months.

In aggregate, the majority of Council members judged that, in view of the expected developments in inflation and the financial market as well as weak domestic demand, the inflation target could be met on the horizon relevant for monetary policy by maintaining a looser policy stance than was currently the case. By contrast, others argued in favour of maintaining the base rate unchanged, referring to high underlying inflation and the structural problems of the real economy.

Members agreed that a further reduction in interest rates could occur if financial market sentiment continued to improve and the medium-term upside risks to inflation remained moderate.

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 by 25 basis points and three members voted to maintain it.

Votes cast by individual members of the Council

In favour of reducing the base rate to 6.50%	**4**	Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, György Kocziszky
In favour of maintaining the base rate at 6.75%	**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 30 October 2012. The minutes of that meeting will be published at 2 p.m. on 14 November 2012.