MINUTES

OF THE MONETARY COUNCIL MEETING

30 OCTOBER 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

Macroeconomic data available since the Monetary Council's last interest rate decision are consistent with the baseline projection in the September issue of the *Quarterly Report on Inflation*. Inflation in September was slightly lower than staff expected, but there are still a number of upside risks to inflation over the next couple of months. Although industrial production rose, confidence indicators and measures of underlying activity point to further weakness in the period ahead, and the latest data on construction and retail sales continue to suggest that domestic demand remains subdued.

Inflation picked up sharply in September 2012, with the consumer price index rising to 6.6% and annual core inflation to 5.3%. Headline inflation and core inflation were 0.6 percentage points and 0.2 percentage points higher respectively, compared with the previous month. The latest inflation figure exceeded market expectations and the previous month's readings, but was lower than the Bank's September projection. The main driving force behind this pick-up in inflation was upward pressure from rising commodity prices (food and crude oil), which affected an increasingly wide range of goods and services included in the consumer basket. However, underlying inflation decelerated somewhat. Downward pressure from slack domestic demand was largely reflected in falling prices of items most sensitive to changes in demand (market services and tradables), which may have been fuelled by the continued negative output gap and the stronger forint exchange in recent months relative to the start of the year. However, the lower outcome for inflation relative to the September projection also partially reflected one-off factors, which are likely to reverse to some extent in the coming months. The pass-through of the food price shock and higher oil prices represent an additional upside risk. Overall, the available data have not altered the short-term outlook for inflation.

Industrial production rose sharply in August 2012, up 4.3% compared with July. New automobile industry capacities and a couple of transient factors may have contributed to the upturn in production. By contrast, the output of the sectors producing for the domestic market continued to be subdued in the weak demand environment, with production slowing across a number of industries within the manufacturing sector. Industrial sales also stagnated relative to the same period of the previous year. The goods surplus fell modestly in August, accompanied by rising exports and imports. Hungary's terms of trade improved significantly relative to the previous month. Despite the improvement, however, confidence indicators point to a deterioration in the external environment and the outlook for domestic activity also worsened compared with previous months. This is suggested by the drop in new orders to below early 2012 levels and the slight decline in German new orders.

News on the performance of the construction industry was also unfavourable. The volume of construction output fell by 5.3% in August relative to both the previous month and a year earlier. Production declined by a total of 7.0% in the first eight months of the year relative to the same period of 2011.

The total volume of retail sales (including vehicle and component sales) was 3% lower in August than twelve months previously. The decline in sales affected a wide range of products. The real net wage bill, one of the most important macroeconomic factors influencing household consumption, fell in a yearly comparison. In addition, continued weak bank lending was also a factor constraining consumption. The latest construction and retail sales data suggest that whole-economy investment and consumption demand remains subdued.

In August, gross earnings rose by 3.8% in the total economy and by 6.6% in the private sector. Regular pay was up 4.9% and 7.9% in the whole economy and the private sector respectively, compared with the same period a year earlier. Earnings growth in the private sector has moderated somewhat in recent months, after rising sharply in the first half of the year. Monthly rates of regular pay growth changed little in the summer months, but it is important to note that employees' wages generally are not adjusted during this period of the year, and therefore wage dynamics in these months contain little information on wage developments for the year as a whole. Wages for the last few months of the year may provide relevant information on wage developments during the entire year. Bonuses are likely to fall, consistent with the weak economic activity. According to seasonally adjusted Labour Force Survey data for August, activity and employment have stopped rising in recent months. The unemployment rate stood at around 10.5% in the period, which was slightly lower than the level at the start of the year, but the numbers of both registered unemployed and long-term unemployed (i.e. those searching for a job for a year or more) increased in September.

The Government has announced two sets of significant adjustment measures in recent weeks. The magnitude of those measures was broadly consistent with the technical assumptions employed in the September issue of the *Report*. At present, the likely impact of the measures on the macroeconomy can only be judged with a considerable degree of uncertainty: they are unlikely to materially affect the outlook for the real economy and inflation next year compared with the September projection, but they may generate upward cost pressure via increases in companies' production costs and lower the economy's growth potential via a reduction in the banking sector's ability to attract capital and the curtailment of lending.

Financial market developments

Sentiment in global financial markets has been volatile in the past month. Favourable macroeconomic data in the United States and China had a positive impact on investors' appetite for risk in the first part of the period. The euro-area periphery experienced a period of relative calm, and the news, although mixed, was slightly on the upside. However, negative news began to dominate in the second half of the period: in the US the quarterly reporting season started with mixed releases, and concerns about the situation in Spain intensified again. Additionally, no important announcements were made at the EU summit, which disappointed the markets somewhat. The details of the planned banking union remain unclear; plans call for continuation of the preparations in 2013, followed by the implementation phase.

Although the roughly 3% decline in the world's leading developed market indices and the higher stock market volatility suggest a deterioration in global market sentiment, a number of indicators point to increased risk appetite over the period as a whole. The EMBI Emerging Market Bond Index fell, and yield spreads on bonds of Mediterranean countries edged lower.

In Hungary, aside from the reduction in official interest rates at end-September, the most important market-moving events during the month were the announcements of the Government's fiscal adjustment measures on 5 and 17 October. No major progress was made on a possible loan agreement with the IMF, but the market did respond positively to the Government's decision to withdraw its proposal to levy a financial transaction tax on the MNB.

Perceptions about the Hungarian economy changed favourably: the improvement in the country's indicators exceeded the declines in global risk premia, yields fell and the forint appreciated. This may have mainly reflected the fiscal adjustments announced on 5 October. Later, however, the country-specific component pointed to an increase in Hungary's risk premia in response to the announcements made on 17 October. Analysts explained the market's favourable response to the first package of measures with the greater share of expenditure side measures and the presence of structural reforms. Although the message of the Government's commitment to meeting the fiscal deficit target is positive, analysts believe that concerns about the outlook for economic growth may have been amplified by the fact that the second package consists almost exclusively of tax increases.

The forint exchange rate fluctuated in a range between EUR/HUF 283 and 287 in the days following the Monetary Council's last interest rate decision, after which it appreciated to the EUR/HUF 278 level in a couple of days from the beginning of October, outperforming other currencies of the region by some 2%. The exchange rate reversed some of this appreciation in recent days and is currently fluctuating in a range between EUR/HUF 280 and 282. There was strong buying interest for the forint by non-resident participants in the spot foreign exchange market.

The five-year CDS premium fell sharply in one month: it reached its low point at around 240 basis points, after declining by 110 basis points. The magnitude of this decline was slightly greater than that in countries with similar risk profiles. Decomposing the change in the risk premium, half of the decline, which characterised the two weeks following the first fiscal announcement, mainly reflected country-specific factors, while the benign international environment had a positive impact on movements in the risk premium over the entire period. The EU's restrictions on uncovered transactions in credit default swaps on EU sovereign issuers, introduced on 1 November, may also have contributed to the decline in CDS premia (and yields); the effects of this were also clearly observable in countries with similar risk profiles. The premium rose above 270 basis points amidst the deterioration in sentiment towards the end of the period.

Movements in foreign currency bond yields also reflected the improvement in risk perceptions. The decline of 80 basis points in the spread on five-year euro-denominated Hungarian government bonds over German Bunds of equivalent maturity was significant in an international comparison.

Secondary market yields on government securities have fallen by nearly the same amount, dropping by 60–70 basis points, at every maturity since the Council's last policy decision, but there were sharp changes in the slope of the yield curve during the month. While yields fell only at the short end of the curve following the interest rate decision and long-term yields rose by 10–30 basis points, they fell only at the longer end in the period following the Government's announcements. This and favourable global sentiment contributed to the ten-year government bond yield declining temporarily to a seven-year low. Interest at the auctions of Hungarian government securities remained strong: issues were oversubscribed several times at every maturity and the Debt Management Agency often sold higher quantities than announced prior to the auctions. Simultaneously with this, non-residents' total holdings of government securities rose to a record level of over HUF 4,900 billion.

The market priced in a high probability of two 25 basis point reductions in official interest rates in the next three months and one 25 basis point reduction with a 50% probability. According to the survey of economists by Bloomberg, 12 of the 14 respondents expect the Monetary Council to lower interest rates by 25 basis points and two expect it to maintain interest rates at its October meeting.

Position of the banking sector

In September, the stock of domestic bank lending to the corporate sector increased, albeit slightly, caused by an increase in short-term forint loans and a decline in foreign currency loans. Average interest rates on low and high-amount forint corporate loans fell slightly in September.

The stock of household loans fell slightly more strongly in September relative to the previous month. This change in the stock of loans resulted from a sharp decline in foreign currency lending and an increase in forint lending, with the composition of the change remaining largely the same as in previous months. New bank lending to households continued to be low. Average interest rates on housing loans and home equity loans fell slightly in September.

The system-wide financial stress indicator (SWFSI), used to measure stress in financial markets of key importance in terms of financial stability, rose in the past month, but remained far below critical levels of stress and is considered low by historical standards. Liquidity risks of the banking sector continued to fall in September, with the liquidity index remaining on a downtrend. Liquidity buffers above the regulatory level increased during the month, indicating that liquidity in the banking sector is at satisfactory levels. The capital stress test index also suggests an improvement in the banking sector's resilience to shocks, mostly thanks to the capital injections by parent banks which were carried out this year. Withdrawals of foreign funds, the high ratio of and potential insufficient provisioning for non-performing loans as well as banks' low earnings potential represent a risk to the smooth operation of the domestic banking sector, which in turn may lead to a further curtailment of lending.

At the end of September, the banking sector's cumulated within-year profits before taxation were HUF 12 billion, which is a very low level. Profitability continued to be highly concentrated among banks. Three of the largest banks are recording losses. Due to weak profitability, domestic banks are at a disadvantage in the allocation of funds by parent banks, which may be reflected in a further decline in the outstanding stock of lending.

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

In the Monetary Council's judgement, economic output was likely to fall this year, with growth only expected to resume in 2013 as Hungary's export markets recovered. The latest economic data confirmed that demand had remained subdued and external economic activity had weakened further. Members agreed that the level of output was below its potential and unemployment remained above its long-term level determined by structural factors. The Council expected the weak demand environment and slack labour market to remain for a longer period of time. The weakness of corporate investment and persistently high unemployment suggested that the economy's potential growth rate was significantly below its pre-crisis level and the Council's previous expectation. However, there was disagreement among members over the size of the output gap. The majority view was that the inflation target could be met on the horizon relevant for policy, given the strong disinflationary impact of significantly below-potential growth. Some members thought that the output gap did not slow inflation to the extent that would be desirable to meet the inflation target under maintaining looser monetary conditions.

Inflation had picked up in September, largely reflecting rises in food and fuel prices. Members agreed that the consumer price index remained high due mainly to increases in commodity prices as well as the effects of tax changes and administrative measures. Inflation was likely to remain significantly higher than the medium-term target this year and next. The disinflationary impact of weak domestic demand was expected to increasingly dominate inflation developments as the upward pressure from one-off price level shocks faded; some members, however, thought that this would not be sufficient to meet the inflation target and that developments in underlying inflation were inconsistent with the inflation target. Members agreed that it was important that increases in wages next year, particularly in the minimum wage, were consistent with changes in whole-economy productivity, in order to reach a higher level of employment and mitigate cost pressures on companies. The majority of members were of the view that the inflation target could be met in 2014 after the temporary inflationary impact of shocks to inflation waned, even if monetary conditions were eased. Some members, however, were of the view that this would only be possible by maintaining current monetary conditions.

Members agreed that although the measures announced in recent weeks had confirmed the Government's commitment to maintaining a low fiscal deficit path, there was considerable uncertainty about the macroeconomic effects of the adjustment measures. And although the short-term outlook for growth and inflation was likely to be broadly unaffected, cost pressures might arise in the medium term and the potential growth rate of the economy might fall, reflecting the reduced ability of the banking system to attract capital and subdued lending activity. Some members noted that the measures represented significant upside risks to inflation. Nevertheless, the Monetary Council agreed that more time was needed to assess the effects of the measures on inflation and the real economy, and therefore the next *Report* would contain a detailed assessment of those effects.

Although there had been a reduction in perceptions of the risk associated with the Hungarian economy in the past month, members held differing views about the roles played by country-specific and global factors as well as by the changes in regulations affecting the CDS market. The majority of members thought that domestic developments over the past month had made a major contribution to the improvement in risk indicators, while others thought this was not so straightforward. One member argued that almost the entire fall in the country risk premium may have been caused by the regulatory change, and therefore that member cautioned against being too optimistic about this factor. Council members agreed about the importance of an agreement between the Government and the European Union and the International Monetary Fund, as such an agreement would contribute to a sustained improvement in risk perceptions and a decline in yields as well as to the sustainability of government debt and would help support lending activity and improve the investment climate.

During the discussion of the policy decision, members summarised their arguments in favour of and against an interest rate reduction. The majority of Council members, preferring an interest rate reduction at this meeting, argued that there continued to be a significant margin of spare capacity in the economy, and therefore the cost shocks hitting the economy did not cause a deterioration in the medium-term inflation outlook. Consequently, those members thought that the disinflationary impact of weak domestic demand was likely to increasingly dominate inflation developments as the effects of the shocks waned. The improvement in global financial market sentiment, coupled with the Government's strong commitment to maintaining a low fiscal deficit, might contribute to a sustained decline in risk premia on domestic financial assets. Taking these factors into account, those members thought that a lower interest rate level was warranted. By contrast, members preferring to maintain interest rates thought that recent developments in inflation and financial markets did not justify monetary policy easing. In their view, the inflation target could only be met by maintaining current monetary conditions. Those members also pointed out that while the interest rate expectations of market analysts had fallen, their inflation expectations had increased gradually in recent months. They felt that the uncertainty about the Government's measures and the decline in the risk premium warranted a more cautious approach to monetary policy than was currently the case. Maintaining interest rates at this meeting would confirm that the Monetary Council was committed to delivering price stability.

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. In terms of the Council's future interest rate decisions, members agreed that the Council should consider a further reduction in interest rates if data in the coming months confirmed that the improvement in financial market sentiment persisted and the medium-term outlook for inflation remained consistent with the 3% target.

Votes cast by individual members of the Council

In favour of reducing the base rate to 6.25%	**4**	Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, György Kocziszky
In favour of maintaining the base rate at 6.50%	**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 27 November 2012. The minutes of that meeting will be published at 2 p.m. on 5 December 2012.