MAGYAR NEMZETI BANK

MINUTES
OF THE MONETARY COUNCIL MEETING
27 NOVEMBER 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 point to lower inflation than in the baseline projection of the September issue of the Quarterly Report on Inflation *and economic activity consistent with the Bank's expectation. Inflation slowed sharply in October, mainly reflecting the fall in fuel prices and subdued growth in administered prices. There was no significant change in domestic economic indicators during the last month. Domestic output fell slightly in the third quarter. There remains a significant margin of spare capacity in the economy. Activity in Hungary's export markets may slow over the period to the end of the year as expected by the Bank.*

The consumer price index slowed to 0.6% in October, with annual core inflation at 5.1%. Inflation developments during the month were driven by lower fuel prices, the exchange rate stabilising at a stronger level in recent months, the Government's measures taking effect in the middle of the year and persistently subdued demand. The commodity price shock developing since the summer months of the year fed through into unprocessed food prices in the autumn months. Processed food price inflation in September and October was slower than the Bank anticipated earlier, but inflation is still expected to pick up in this product group in the coming months, reflecting recent changes in unprocessed food prices. There was a slight decline in measures capturing the medium-term outlook for inflation.

Industrial production fell sharply month on month in September 2012, with the seasonally adjusted level of production declining by 1.7% relative to August. The steady slowdown since 2011 has been explained by the gradual weakening in external activity in recent quarters, in addition to persistently slack domestic demand, which has been only partially offset by the rising output of the automobile sector.

The outlook for domestic industrial activity deteriorated relative to previous months. The volume of new orders dropped below the levels seen at the start of the year, following the sharp rises in March–April, and new orders in Germany also fell slightly. On balance, the underlying picture for domestic industrial production is unlikely to change materially over the period to the end of the year.

Construction output rose in August, partly reflecting the very low base and the sharp expansion of infrastructure investment by the Government (road construction and railway reconstruction). In September, construction output rose by 6.8% relative to a year earlier and by 5.1% on the previous month. Most of the sharp increase in September is viewed as temporary, which may be partly reversed by the completion of the Government's construction projects currently underway.

The volume of retail sales was 3% lower in August than twelve months previously. The short-run measures of retail sales point to a slow but steady decline in household purchases. The decline in retail sales affected a wide range of products. Demand for consumer durable goods continued to fall most sharply. The household confidence indicator remained at a low level. Based on the latest data available, whole-economy investment and consumption demand was modest in the third quarter.

In September, gross average earnings rose by 3.7% in the total economy and by 6.6% in the private sector. Regular pay was up 4.3% and 6.8% 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. This slowdown affected industries within manufacturing more than market services. Possible explanations for this are that regulations on payment for shift work were changed in the course of the year and industrial production declined in September. The change to the regulations on payment for shift work may lead to a sustained fall in earnings. On the other hand, if the weak performance of industry in September explains the slowdown in earnings growth, then a partial reversal cannot be ruled out in the coming months. Data for the last month of the year will provide an opportunity to assess how long this process will last and to make an informed judgement of this year's developments in wages.

Financial market developments

The first part of the period since the Monetary Council's last policy decision — and prior to the US presidential elections — was characterised by a wait-and-see mood in markets. Following the elections, however, concerns related to the automatic fiscal stabilisers in the US came to the fore, and market sentiment was driven by uncertainties about the stabilisation package in the latter part of the month. The pessimistic forecast issued by the European Commission about the debt position of Member States and the prospects for growth led to a deterioration in sentiment. Economic forecasts for China, however, suggested a slightly more upbeat picture, and a couple of macroeconomic releases in the US and favourable developments in the European debt crisis contributed to an improvement in sentiment. On balance, the major equity indices in developed markets fell, and emerging market yields as well as yields on bonds of euro-area periphery countries rose slightly. The dollar appreciated by some 1.5% against the euro.

Movements in most domestic market indices have been modest since the Council's last interest rate decision, closely following global market moves. On the domestic front, developments related to the assumption by the Hungarian Government of local authority debt, the announcement of a HUF 90 billion fiscal adjustment package as well as news on the negotiations with the IMF were the major market-moving events of the month. Following the latest statements related to the IMF negotiations and the measures announced by the Government last week, the number of economists saying that the Government and IMF would not reach an agreement increased.

Measures of the market's perceptions of the risks associated with the Hungarian economy suggested a mixed picture. The forint exchange rate fluctuated in a relatively narrow range between EUR/HUF 280 and 286, with small swings. Movements in the currency were closely aligned with those in with the Polish zloty throughout most of the period. Developments in non-residents' currency positions and prices of foreign exchange derivatives paint a less favourable picture of the market's expectations. Yields in the secondary market of government securities have been falling since the Council's last interest rate decision; long-term yields have stagnated or risen slightly in the past six months, while those at the shorter end of the curve have tended to edge downwards. Non-resident holdings of Hungarian government securities were little changed. Demand at the auctions of government paper was volatile in the period.

The Hungarian CDS spread has risen significantly since the Monetary Council's last policy decision, after falling sharply in the previous month. From its initial level of 270, the spread rose to above 320 and then fell back to levels around 300. Decomposing these changes, country-specific factors accounted for the larger part of the increase in the Hungarian risk spread. Although the reaction from the market to news of the downgrade of Hungary's sovereign debt at the end of the period was only moderate, it reflected an increase in risks associated with domestic financial assets.

Of the 20 respondents to the November Reuters poll, a large majority of 17 analysts expected the Monetary Council to lower interest rates by 25 basis points at its November meeting and three respondents expected it to leave rates on hold. However, analysts' expectations of the Council's likely policy decision at its December meeting were divided. Based on FRA rates, market participants expect the easing cycle to continue.

Position of the banking sector

In October, domestic bank lending to the corporate sector fell again following the slight increase in the previous month. The fall mainly reflected a decline in long-term foreign currency lending, while the stock of forint loans increased. Average interest rates on forint corporate loans fell, according to preliminary data. The average interest rate on new loans fell by 29 basis points, taking the total decline to 95 basis points since August.

The stock of housing loans to the household sector fell more in October than in previous months. This decline resulted from a combined fall in foreign currency and forint loans, although the fall in the latter may have been strongly related in part to payments of wages and welfare benefits brought forward to October. New bank lending for house purchase continued to be weak, remaining at a very depressed level since the completion of the early repayment programme. In October, average interest rates on housing loans and consumer loans both fell.

According to the results of the lending survey conducted in October 2012, conditions on both housing loans and consumer loans eased in the third quarter of 2012, mainly affecting price terms. In the corporate market, non-price credit terms continued to tighten, similar to what was seen in previous quarters. Banks explained the change by the economic outlook and industry-specific problems. The survey results suggest that credit conditions are unlikely to change significantly in any of the loan segments in the current and the following quarter.

The system-wide financial stress indicator (SWFSI), used to measure stress in financial markets of key importance in terms of financial stability, changed little in the past month. Liquidity risks of the banking sector remained low in October. 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 for the third quarter suggests that the banking sector's resilience to shocks is adequate, mostly thanks to the capital injections by parent banks which were carried out this year. Looking forward, however, the recent announcement by the Government that the bank levy would be maintained represents an additional risk. Withdrawals of foreign funds, the high ratio of and potentially 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 significantly lower than in the same period of the previous year. The sector's weak performance in the third quarter was mainly related to loan loss provisioning for bad and doubtful assets. The banking sector's profitability is extremely low by international standards, which continues to indicate a significant competitive disadvantage for banks. There is a large asymmetry across participants in terms of profitability.

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

In the Monetary Council's judgement, the Hungarian economy was in recession and external and domestic factors both pointed to weak growth in the period ahead. Growth was only expected to resume next year, if the country's export markets bounced back. The level of output was below its potential, and unemployment remained above its long-term level determined by structural factors. The weakness of corporate investment and persistently high unemployment suggested that the economy's potential growth rate was significantly below its pre-crisis level. The majority of members thought that there continued to be a significant margin of spare capacity in the economy, and therefore the cost shocks hitting the economy had no adverse effect on the medium-term outlook for inflation, and the disinflationary impact of weak domestic demand would dominate as the impact of cost shocks waned. Other members, however, were of the view that the sharp decline in potential output reduced the disinflationary impact of weak domestic demand, due to the postponement of investment, the low availability of credit and the unpredictable regulatory environment.

Monetary Council members agreed that the slowdown in CPI inflation in October mainly reflected the fall in fuel prices and the moderation in administered price inflation. The short-term outlook for inflation had improved, mostly as a result of favourable developments in non-core inflation items. The consumer price index remained high, due primarily to rises in food prices as well as the effects of tax increases and other administrative measures. Inflation in 2012 was likely to significantly exceed the target and remain above it next year, though less so than in 2012; however, the disinflationary impact of weak domestic demand was expected to increasingly dominate inflation developments as the upward pressure from one-off price level shocks subsided. The majority of Council members concluded that the disinflationary impact of weak demand would be sufficient to help meet the 3% inflation target in 2014, even with looser monetary conditions than currently. Other decision-makers thought that, based on information currently available, it was necessary to maintain interest rates in order to meet the target and that the Government's measures, raising the costs of companies, represented a significant upside risk to inflation. Those members also noted that inflation expectations were increasingly less well anchored against the background of strong inflationary pressures in the economy. Council members agreed that it was crucial that increases in wages next year, particularly in the minimum wage, were consistent with changes in whole-economy productivity in order to reduce upward pressures on companies' costs and reach a higher level of employment.

Decision-makers also agreed that the measures announced by the Government had confirmed its commitment to maintaining a low fiscal deficit path. However, the Council judged that higher risks related to a possible agreement with the multinational organisations might have an adverse impact on perceptions of the risks associated with the economy. Some decision-makers expressed their concern that no such negotiations were underway. Members agreed on the importance of reaching 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. The majority of members judged that the downgrade of Hungary's sovereign debt by S&P might also adversely affect perceptions of the risks associated with the economy, even if the move had not had an immediate, tangible impact on the market. Decision-makers agreed that global market sentiment was supportive at present, which had a positive impact on perceptions about Hungary. However, some members noted that this situation could not necessarily be sustained in the longer term, that the fundamental problems of the euro area had remained unresolved and that perceptions of the risks facing the economy relative to other countries had increased in the past month.

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 believed that there remained a significant margin of spare capacity in the economy, the cost shocks hitting the economy did not cause a deterioration in the medium-term inflation outlook, and therefore 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, for those members a lower interest rate level was warranted. Members preferring to maintain interest rates thought that the fiscal measures raised companies' production costs and restrained potential growth, and therefore led to a deterioration in the medium-term inflation outlook. Furthermore, they felt that uncertainty around future developments in the risk premium did not allow the Council to ease policy at this meeting. They judged that the inflation target could only be met by maintaining the base rate.

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 the improvement in financial market sentiment continued and the medium-term outlook for inflation was consistent with the 3 per cent target.

Votes cast by individual members of the Council

In favour of reducing the base rate to 6.00%	**4**	Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, György Kocziszky
In favour of maintaining the base rate at 6.25%	**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 18 December 2012. The minutes of that meeting will be published at 2 p.m. on 16 January 2013.