MINUTES

OF THE MONETARY COUNCIL MEETING

18 DECEMBER 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

Recent economic developments have been marked by a contrast between improving risk perceptions and subdued domestic real economic activity. Output continued to decline, owing to both domestic and external factors. Inflation remained persistently above the target, despite the recessionary environment. Looking ahead, inflation is expected to slow significantly in the short term, mainly reflecting movements in items excluded from the core measure. In the medium term, however, the passing on of the burden placed on companies by the Government's measures is likely to add to cost-push inflationary pressure. Inflation will remain above the target next year, reflecting the effects of measures to meet the Government's deficit target and the cost shocks hitting the economy, and is only expected to ease back to 3% in the second half of 2014.

The Hungarian economy fell into recession in early 2012, and growth is expected to be fairly subdued over the next two years as well. The weak performance of the economy stems partly from the slowdown in global economic activity and partly from the effects of domestic factors. Although the slowdown in external markets is acting as a drag on Hungarian export growth, exports will remain the source of economic growth. Domestic demand growth is likely to be modest, due to protracted deleveraging by domestic economic agents. This effect may be amplified by persistently tight credit conditions and the significant uncertainty about the economic environment. Consumption and investment are expected to pick up slowly in 2014, following a decline next year. Potential economic output is unlikely to grow materially over the next two years, due to persistently weak investment activity. In the Bank's current projection, output remains below its potential level over the entire forecast period.

Companies' demand for labour is likely to remain subdued for quite a while, as economic activity will remain weak and the Government's measures will lead to increases in companies' costs. Employment is only expected to start increasing again in 2014. The rise in unemployment partly reflects structural factors; however, even taking account of this, the labour market is likely to remain loose during the period ahead. Nominal earnings growth has picked up sharply this year, driven in large part by the administrative wage increases at the start of the year. The Government's wage compensation scheme cushioned the upward impact of high earnings growth on companies' costs. Nevertheless, unit labour costs increased, leading to a deterioration in corporate profitability. The job protection scheme to be launched next year is expected to lower the costs of employing labour under the programme.

The annual rate of inflation slowed sharply in the autumn months, but remained above the target. The recent high rates of inflation mainly reflect the effects of commodity price shocks and the Government's indirect tax increases. The modest increases in the underlying measures of inflation suggest that weak demand continues to have a disinflationary impact on prices. Looking ahead, inflation is expected to slow significantly in the short term, mainly reflecting movements in items excluded from the core measure. In the medium term, however, the

Government's measures which increase companies' production costs may generate additional inflationary pressure. Second-round effects are not expected, given the negative output gap over the entire forecast horizon. Inflation is likely to remain significantly above the 3% target over most of the forecast horizon, with the inflation target only likely to be met in the second half of 2014.

The macroeconomic factors determining the path of interest rates consistent with the projection by Bank staff continue to point in opposite directions. The negative output gap would, in its own right, justify a looser monetary policy stance. The baseline inflation projection is based on the assumption that companies will adjust to the increase in their production costs in part by changing their prices, despite the weak demand environment. That in turn is likely to generate additional inflationary pressure. In the current projection, the factors pointing in the direction of tightening and easing broadly cancel each other out, and room for a reduction in interest rates will be available in the second half of the forecast horizon.

Financial market developments

Sentiment has improved somewhat in international financial markets since the Monetary Councils' last interest rate decision. A further support package for Greece, the success of the bond purchase programme and the transfer of the Spanish bank bailout package led to an improvement in the prospects for euro-area crisis management. The blueprint for a deep and genuine economic and monetary union, presented by the European Commission, was also favourably received by markets. However, the downgrade by Moody's of France and the ESM altered the picture somewhat. In addition, news related to the resignation of Italy's Prime Minister also contributed to a temporary deterioration in sentiment. The debates in the US about fiscal austerity measures and the raising of the federal debt ceiling remained the focus of attention. In this regard, initial statements pointed to a sharp division of views; however, the changed tone of the discussions in recent days has once again provided grounds for optimism that an agreement would soon be reached. Statements and measures by the new Chinese leadership, committing to the priority of maintaining economic growth, had a positive impact on markets.

The world's leading equity indices have risen in recent weeks; indicators of risk appetite showed a slight decline and a significant improvement in investors' appetite for risk in the US and emerging markets, respectively. Government securities yields in euro-area periphery countries have stagnated or fallen over the past two weeks. In Italy, the fall in yields seen earlier in the period was partly reversed in response to domestic political uncertainties, while in Greece yields fell significantly, due to the announcement of a further package of support for the country and the start of the bond purchase programme. The euro appreciated against the US dollar, with the exchange rate rising to the EUR/USD 1.3000 level. The Swiss franc depreciated slightly against the euro. The price of Brent crude oil fell a little as the conflict in the Near East abated.

Movements in domestic financial market indicators have been moderate since the last interest rate decision, following the international market trends. Domestic news had little impact on the

market: neither the interest rate decision nor the country's downgrade by S&P had a lasting impact on market movements. It is worth noting that market reaction to the news related to the talks with the IMF was muted. The Government announced that the Government Debt Management Agency planned to issue a foreign currency bond in the first quarter of next year. The forint exchange rate moved within a relatively narrow band throughout the period, weakening slightly since the previous interest rate decision. According to the Reuters foreign exchange market poll conducted in early December, expectations related to the exchange rate of the currency barely changed. The Hungarian CDS spread virtually stagnated in the period, with country-specific and global factors cancelling each other out. Spreads on Hungarian foreign currency bonds fell slightly.

In the secondary market, government securities yields declined sharply, with the benchmark yield on the ten-year bond falling to a 2.5 year low. Demand at the auctions of government paper was strong. Non-resident holdings of forint-denominated government securities rose further and the average time to maturity of bonds in non-residents' portfolios fell.

Based on interbank rates, interest rate expectations shifted down further: the market priced in a 25 basis point reduction in interest rates over the next two months.

Position of the banking sector

Based on preliminary data for the seven largest Hungarian banks, domestic lending to the corporate sector fell. The fall mainly reflected a decline in foreign currency lending, while the stock of forint loans remained broadly unchanged. Average interest rates on forint corporate loans fell, according to preliminary data. The average interest rate on new loans fell further in October, taking the total decline to nearly 100 basis points since August.

The stock of housing loans fell more strongly in November than in previous months, according to preliminary data. New bank lending to households continued to be weak, remaining at a very depressed level since 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 next quarter.

The system-wide financial stress indicator (SWFSI), used to measure stress in financial markets of key importance in terms of financial stability, has changed little since the middle of November, remaining at a historically low level. Liquidity risks of the banking sector also 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.

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

Members of the Monetary Council agreed that the outlook for growth of the Hungarian economy had deteriorated and that growth was likely to be subdued over the next two years. Exports were expected to remain the primary source of growth even as external demand continued to soften, while domestic demand would remain weak. Some members noted that the country's export performance was below the average of the region. Balance-sheet deleveraging by economic agents would continue, with consumption and investment likely to fall further, mainly due to tight credit conditions and the uncertain business environment, followed by a gradual recovery from 2014. The potential output of the Hungarian economy was likely to increase very modestly over the next two years, reflecting the sustained weakness in investment and persistently high unemployment.

In the Council's judgement, the rise in unemployment in recent years partly reflected permanent structural problems, but the labour market was likely to remain loose in the period ahead, even taking account of this factor. In addition to the weak outlook for growth and companies' poor profitability, the increases in the minimum wage and the guaranteed minimum wage for skilled workers were also impeding a recovery in employment, which was only likely to start in the private sector in 2014. Although the job protection scheme to be launched next year was expected to lower the costs of employing labour under the programme, the Government's measures, resulting in a deterioration in private sector profitability, suggested that companies would continue to adjust going forward.

The macroeconomic outlook was surrounded by a considerable degree of uncertainty. With a negative output gap and inflation remaining at high levels, the latest government measures would raise companies' production costs. The high rate of inflation mainly reflected the effects of commodity price shocks and the Government's indirect tax increases, while the pace of underlying inflation remained moderate. Council members agreed that inflation was likely to slow significantly in the short term, mainly reflecting movements in the prices of non-core items. In the medium term, however, the burden placed on companies by the administrative measures and the minimum wage increase might strengthen the pass-through of higher costs to prices, which in turn might generate cost-push inflationary pressure along the entire production chain. With the outlook for growth and domestic demand remaining low, one key issue as well as a source of considerable uncertainty in terms of the medium-term inflation outlook relevant for monetary policy was the extent and timing of the pass-through to prices of the Government's measures. This mainly depended on the ability of the corporate sector to adjust to the increase in production costs. The relative strength of these adjustment channels depended on the extent to which the availability of unused capacity was able to exert discipline on price and wage-setting and inflation expectations were well-anchored.

The majority of Council members thought that the extent to which the adjustment would be reflected in prices was limited due to weak domestic demand, and that companies were more

likely to adjust by reducing wages and laying off workers. Those decision-makers thought that companies had less room to pass on the increased production costs into prices, due to the significant margin of unused capacity. Inflation was therefore expected to be more moderate than in the baseline projection in the medium term, which in turn would permit looser monetary conditions.

Other members, however, were of the view that adjustment through prices could not be ruled out. Data for early next year could help judge the precise extent of pass-though into prices and the medium-term outlook for inflation, which therefore warranted a wait-and-see approach to policy for now. Those members judged that if companies expected the high inflation environment of recent years to persist for some time, the pass-through of cost pressures to prices might be stronger. Moreover, the prolonged deterioration in profitability might prompt companies to further reduce investment spending, which could in turn lead to a slowdown in potential output growth. One member noted that, based on the experience of recent years, inflation might remain high even in a recessionary environment and concluded that companies were likely to seek compensation for the deterioration in the outlook for profits by raising prices to a greater extent than assumed in the baseline projection or expected by the majority of Council members. Moreover, economic agents' higher inflation expectations might also affect wage-setting, in addition to price-setting decisions, which in turn would impede the recovery in profitability in the medium term and would merely lead to a higher nominal path. Corporate adjustment through higher price and wage dynamics could be prevented by tightening monetary policy. In the context of the announced reduction in household energy prices, some members noted the symptom of repressed inflation, which, although tending to reduce consumer prices in the short term, would necessarily increase inflation over the medium term.

Council members agreed that in 2012 and 2013 the fiscal deficit was likely to be broadly consistent with the Government's target. The measures announced in recent months were likely to lead to a significant improvement in the fiscal balance in 2013. There was considerable uncertainty about the expected size of deficit in 2014. The Government's commitment to maintaining a low fiscal deficit path might contribute to long-term fiscal sustainability, but the slowdown in potential growth might have the opposite effect.

Decision-makers also agreed that it was important to reach an agreement between the Government and the European Union and International Monetary Fund, as that 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.

There had been a significant improvement in perceptions of the risks associated with the economy in recent months, mainly reflecting global factors. In the Council's judgement, there were both upside and downside risks to changes in risk perceptions. Members agreed that the contrast between weak global economic activity and strong risk appetite in international financial markets warranted a cautious monetary policy stance. For a majority of members, however, progress with the institutional reforms in the euro area, the reduction in fiscal risks in the US as well as expectations related to the success of domestic fiscal consolidation might

increase the room for interest rate policy manoeuvre in Hungary. By contrast, some members were concerned about the uncertainty as to whether the improved sentiment in financial markets could be maintained, which warranted a wait-and-see approach to policy. Several members noted that the improvement in investor confidence about Hungary might prove fragile, as was highlighted by the rapid weakening of the exchange rate on the day prior to the meeting.

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% target.

Votes cast by individual members of the Council

In favour of reducing the base rate to 5.75%	**4**	Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, György Kocziszky
In favour of maintaining the base rate at 6.00%	**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 29 January 2013. The minutes of that meeting will be published at 2 p.m. on 13 February 2013.