MINUTES

OF THE MONETARY COUNCIL MEETING

29 JANUARY 2013

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

The majority of macroeconomic data becoming available over the past month were consistent with the baseline projection in the Bank's December *Quarterly Report on Inflation*. Inflation in December turned out to be slightly lower than Bank staff expected, but data for the early months of 2013 will be more informative in terms of future price and wage developments in the economy. Although industrial production picked up, data on external activity and confidence indicators point to unfavourable trends in the period ahead, while construction and retail trade data continue to indicate subdued domestic demand.

Inflation fell slightly in December 2012, with the consumer price index dropping to 5.0% and annual core inflation to 4.9%. Both headline inflation and core inflation eased by 0.2 percentage points relative to the previous month. The available data came in somewhat short of the staff's expectations. The difference was due lower inflation in food, alcohol and tobacco prices. Despite the rise in unprocessed food prices, the increase in processed food prices was less sharp than experienced during the food price shocks of 2007 and 2010, which, in turn, points to strong downward pressure on prices from weak domestic demand. Overall, the available data by themselves represent a slight downside risk to the outlook for inflation. In recent weeks, however, the forint exchange rate has been weaker than assumed at the time the December projection was produced, which represents an upside risk. Annual demand-sensitive inflation and the sticky price inflation index were broadly unchanged. To summarise, the data suggest a largely unchanged picture of inflation; data for the early months of 2013 will be more informative in terms of underlying inflation.

Hungary's GDP fell by 1.5% in the third quarter of 2012. Information from the past month suggests that risks to fourth-quarter growth are mostly on the downside. Industrial production picked up slightly relative to the previous month, but performance continued to weaken across a wide range of industries. Goods trade declined in November relative to the previous month, and the country's trade surplus fell slightly, accompanied by declining export and import volumes. Recent data on external economic activity and confidence indicators point to a further slowdown in the period ahead. The volume of industrial production fell sharply again in November relative to a year earlier, following the temporary pick-up in the third quarter.

However, new orders for vehicle industry exports increased markedly even adjusted for one-off effects. Consequently, the improvement in the performance of the automobile industry may offset the decline in production in other industries. The rise in new export orders represents an upside risk for early next year relative to the projection in the December *Report*.

The total volume of retail sales fell by 3.2% in October relative to the same period a year earlier. This decline in sales affected a wide range of products. The real net wage bill, one of the most important factors influencing household consumption, continued to decline in a year-on-year comparison. In addition, continued weak lending activity reduces the funds available for consumption. The data available since publication of the *Report* was consistent with the picture presented in the *Report*, and therefore household consumption is expected to decline further.

In November, gross average earnings grew by 5.4% in the whole economy and by 6.2% in the private sector. The index of private sector earnings growth slowed relative to previous months, reflecting reductions in regular pay and bonuses. In terms of both gross average earnings and regular pay, the alternative measures of wage inflation have remained broadly unchanged since the beginning of the year, and declines were registered in November. The November data was in line with the Bank's expectation, with the reduction in wages materialising as projected in the *Report*. However, data for early 2013 are expected to provide guidance on underlying wage developments.

Financial market developments

Sentiment has continued to improve somewhat in international financial markets since the Monetary Council's last interest rate decision. Although the improvement in sentiment stalled, reflecting concerns over the programmed fiscal contraction in the US, the agreement in Congress providing temporary relief in early January fostered some optimism again. In addition, a number of better-than-expected macroeconomic data, the overall favourable US quarterly reporting season, the decision on EU bank oversight, the extension for banks of the period to meet the Basel liquidity rules by four years and the better-than-expected upgrade of Greek debt also contributed to the improvement in sentiment.

The world's leading equity indices rose by 1%–7% above their mid-December levels and the major emerging-market equity indices achieved similar gains. Commodity prices rose, with the price of North Sea Brent increasing by 4%. CDS composite indices came down and bond spreads in emerging markets declined. The VIX index, a measure of equity market volatility, fell back to levels last seen in 2007. In foreign exchange markets, safe haven currencies weakened, in line with the improvement in investors' appetite for risk. Movements in emerging-country currencies were mixed, with the indicators of foreign exchange market risk at moderate levels overall.

The performance of domestic assets varied over the past five weeks. There was an improvement in perceptions of risks facing the economy, as reflected in movements in CDS premia and foreign currency bond spreads, but the forint depreciated markedly. Yields on government securities fell further at the shorter end of the curve, but the improvement was reversed at longer maturities towards the end of the period. The long-term forward spread over the euro rose sharply in the past four weeks, breaking a declining trend which began in September.

The forint has depreciated by nearly 3% since the Monetary Councils' last interest rate decision: from EUR/HUF 288 at the beginning of the period the exchange rate weakened to EUR/HUF 297 in two sharp sell-offs. This depreciation was driven mainly by country-specific factors: uncertainty surrounding the change at the top of the MNB's management in March and speculation about the introduction of unconventional policy tools, possibly leading to the forint's depreciation, both contributed to the weakening of the exchange rate. The latest expectations by forecasting institutions show a clear deterioration relative to the Reuters poll conducted in early January: against a median expectation of EUR/HUF 285, the latest forecasts are for the exchange rate to move in a band between EUR/HUF 285–300. In the CEE region, the Czech koruna and the Polish zloty depreciated by nearly as much as the forint: heightened expectations of an official interest rate in Poland and verbal intervention aimed at weakening the exchange rate in the Czech Republic contributed to the depreciation of the zloty and the koruna, respectively.

FRA rates imply a 25 basis point reduction in interest rates at every second Council meeting, in addition to the reduction in January. The market expects the trough of the current interest rate cycle to be around 4.75%. The overwhelming majority of economists polled by Reuters also expect that the Council will reduce the policy rate to 5.50% at its January meeting. Interest rate expectations for the end of 2013 have changed little relative to the December survey: analysts continue to expect the base rate to be 5.00%. Economists gave forecasts of the exchange rate for the end of 2014 for the first time, with the median expectation also being 5.00%.

Position of the banking sector

Outstanding bank lending to the corporate sector fell sharply in December. As seen in previous years, this sharp decline at the end of the year may have been explained by accounting motives related to the balance sheet date. The outstanding stock of lending was consistent with the Bank's expectation. Average interest rates on forint corporate loans continued to fall in the final month of the year. The average interest rate on new loans was 30–40 basis points lower than in the previous month. The total decline in the average interest rate amounted to 1.0%–1.5% since the end of August.

The stock of housing loans was also down sharply in December, with the decline in forint loans accounting for around half of the fall. The majority of this affected overdrafts, which may have been related to bonus payments towards the end of the year, based on the experience of previous years. New housing lending continued to be low. In December, the average interest rate on housing loans rose. By contrast, the average interest rate on home equity loans fell further.

The index, used to measure stress in financial markets of key importance in terms of financial stability, has virtually stagnated recently, remaining at historically low levels. The surplus of banks with liquidity buffers remained at the previous high levels at the end of the year, but the deficit of banks with liquidity shortages continued to rise. Looking forward, the maintenance of the levy on banks poses a risk in terms of the sector's capital adequacy, while profitability remains weak. Withdrawals of funds, the high stock of non-performing loans, the potentially insufficient coverage for loans as well as low profitability represent key risks for the operation of the domestic banking sector. That in turn may lead to a further curtailment of lending.

In contrast with previous years, withdrawals of external funds from the banking sector were not significant. Over the year as a whole, the stock of external funds of the entire banking sector fell by HUF 1,740 billion or 23%, according to preliminary December data. That is broadly in the same order of magnitude as in 2011.

Accordingly to preliminary data, the banking sector's within-year cumulative profits before taxation were HUF -51 billion in 2012. There continued to be a high concentration and an asymmetry among banks in terms of profitability. The sector's overall capital adequacy ratio remained at appropriate levels across the sector, but showed an asymmetry among individual banks.

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

In the Monetary Council's judgement, economic growth was likely to resume this year following last year's recession, but both external and domestic demand factors pointed to only modest growth in the period ahead. Deleveraging by domestic economic agents was likely to continue, and consumption and investment were expected to decline further this year, followed by a slow recovery from 2014. The level of output would be below potential and unemployment would remain above its long-term level determined by structural factors. The weakness in investment and persistently high unemployment suggested that the potential growth rate of the economy was significantly below its pre-crisis level and was likely to remain weak over the next two years. The Council expected weak demand conditions to persist, which the majority of members thought would ensure that inflation returned to rates close to the 3% inflation target as the impact of temporary shocks waned. However, some members concluded that the disinflationary impact of weak demand was not strong enough to ensure that the inflation target could be met by maintaining looser monetary conditions.

Inflation had slowed in December, mainly reflecting the decline in the prices of durable goods, processed foods and fuels. The moderate pace of underlying inflation reflected the impact of weak domestic demand. A further reduction in the pace of underlying inflation was required to be able to meet the target in the medium term. There had recently been a significant improvement in the short-term outlook for inflation, mainly due to the government measures affecting the prices of non-core items. Council members agreed that the extent and timing of the pass-through of higher corporate costs to prices due to the government measures, in addition to the subdued outlook for growth and weak domestic demand, would be a key factor in terms of the medium-term inflation outlook relevant for monetary policy. Significant uncertainty remained about the extent and timing of the pass-through of higher production costs, with members continuing to have differing expectations in this regard.

The relative strength of these adjustment channels depended on the extent to which unused capacity was able to exert discipline on price and wage-setting and inflation expectations were well-anchored. The majority of members thought that, due to the weak demand environment and unused capacity in the economy, companies had limited room to pass on higher production costs into prices, and therefore the inflation target could be met at the horizon relevant for policy. By contrast, some members were of the view that most of companies' spare production capacity had already been reduced, as in the weak demand environment companies had responded to the deterioration in their profitability mainly by raising prices, as recent experience had demonstrated. Moreover, expectations may have become less anchored due to inflation remaining persistently above the target, which in turn might also increase the likelihood of adjustment through pricing. Decision-makers agreed that the macroeconomic data to be released in the first quarter would reduce uncertainty about companies' behaviour.

One member thought that the interest rate reductions could not materially contribute to growth, due to the existing strong constraints on lending, and therefore there was no reason to run the risk of higher inflation. Another decision-maker noted that market analysts expected above-target inflation as interest rates continued to be reduced, which suggested that the market did not consider the Council to be committed to reining in inflation; that member judged that at that point it was not enough for members favouring monetary easing to assert the opposite simply through communication.

The improvement in global risk appetite had continued over the past month, but the contrast between buoyant sentiment in international financial markets and the subdued outlook for global growth continued to pose a risk. Meanwhile, domestic risk premia had not moved significantly in either direction. Council members continued to share the view that it remained crucial that an agreement between the Government and the European Union and International Monetary Fund be reached, as this would contribute to further declines in risk premia, which in turn would contribute to the sustainability of government debt and would help support lending and enhance the predictability of the investment environment.

Decision-makers' views were divided on the causes of the forint depreciation in recent weeks. Although members agreed that a sustained, large depreciation of the currency was unfavourable in terms of both the inflation outlook and financial stability risks, the majority of decision-makers explained the weakening of the forint by market uncertainty about the course of monetary policy following the change at the top of the Bank's management and fears about the use of unconventional policy tools. In their judgement, virtually unchanged CDS spreads and government securities yields implied that perceptions of the risks associated with the economy had not increased; the benign global financial market environment and the Government's commitment to maintaining a low fiscal deficit path might contribute to a sustained decline in risk premia on domestic assets. All these factors had warranted and allowed a further cautious easing of monetary conditions. By contrast, some members of the Council were of the view that past interest rate cuts and those priced in by the market had played a distinct role in the depreciation of the forint since last August and that in the current conditions reducing interest rates further would pose a risk to meeting the inflation target in the medium term, and instead the Council should take a more cautious, wait-and-see policy stance.

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 would only consider a further reduction in the policy rate if the medium-term outlook for inflation remained consistent with the Bank's 3% target and the improvement in financial market sentiment was sustained.

For Monetary Council members, it was important to emphasise that the monetary policy instruments currently available allowed enough room for manoeuvre to maintain a monetary policy stance consistent with the current outlook for inflation and the real economy. Furthermore, they agreed that under domestic circumstances expanding the range of unconventional policy tools might provide effective support only during times of acute financial market stress.

Votes cast by individual members of the Council

In favour of reducing the base rate to 5.50%	**4**	Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, György Kocziszky
In favour of maintaining the base rate at 5.75%	**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 26 February 2013. The minutes of that meeting will be published at 2 p.m. on 13 March 2013.