MAGYAR NEMZETI BANK

MINUTES
OF THE MONETARY COUNCIL MEETING
26 MARCH 2013

Article 3 (1) of the MNB Act (Act CCVIII of 2011 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 GDP figure for the final quarter of 2012 and the inflation data for the early months of 2013 surprised in the same direction. There continues to be a significant degree of spare capacity in the economy, consistent with the weaker-than-expected GDP outcome for the fourth quarter, and the output gap has widened over recent quarters. Lower-than-expected price increases at the beginning of the year reflect the strong disinflationary impact of the real economic environment. Base effects and reductions in administered energy prices at the start of the year also contributed to the sharp decline in inflation. In the face of subdued demand, the ability of companies to raise consumer prices is limited, and therefore modest increases in production costs may be a key factor in improving corporate profitability. Labour market data for the first few months of the year show early signs of this.

In February 2013, the consumer price index dropped to 2.8% and core inflation to 3.6%. The decline in inflation mainly reflected developments in food prices and the fading upward effect on the price index of earlier increases in indirect taxes, in addition to the 10% reduction in administered energy prices. Measures of underlying inflation and the historically low annual index of market services both reflect the strong downward impact on prices of weak domestic demand. Against this background of subdued demand conditions, the pass-through into consumer prices of government measures leading to increases in companies' production costs is likely to be limited.

According to the second release, Hungary's gross domestic product fell by 2.7% in the fourth quarter of 2012 relative to the same period of the previous year. This was consistent with an annual decline of 1.7%. The economic downturn deepened in the final quarter of 2012, reflecting the slowdown in activity at home and abroad, in addition to idiosyncratic effects in some sectors. The latter were particularly strong in the case of the decline in agricultural production due to adverse weather conditions and weak industrial production as a result of work stoppages around the end of the year. On the demand side, the contribution of net exports to growth weakened, due mainly to one-off factors also affecting industry as discussed earlier, while domestic demand remained muted.

Relative to the previous month, industrial production increased markedly in January, fully reversing the decline in December. The data confirmed that the performance of industry at the end of last year mainly reflected temporary influences rather than a deterioration in fundamentals. In contrast to previous months, output grew across most industry sectors. Within manufacturing, vehicle production rose strongly in January, with the expansion of capacity in the most important automobile plants expected to continue in the first quarter. The trade surplus increased strongly in January relative to the previous month, but due to high growth in imports the goods surplus remained below the average level seen in the second half of 2012. Confidence survey indicators at home and abroad began to show signs of stabilisation, and short-term measures point to a modest increase in the coming months.

According to the preliminary data, the narrow measure of retail sales (i.e. excluding sales of vehicles and components) declined by 4.1% in January 2013 relative to the same month of the previous year, suggesting continued subdued consumption and cautious consumption behaviour of households.

In January, gross average earnings grew by 2.5% in the whole economy, by 3.0% in the private sector and by 0.9% in the government sector (including people employed in public work programmes) relative to a year previously. In the private sector, the annual index of regular pay fell sharply relative to the previous year, in addition to gross average earnings. Earnings growth slowed sharply in the services sector, in line with the moderate price increases in the sector at the beginning of the year and the continuing decline in retail sales in early 2013. The alternative wage inflation index, based on regular pay, indicated a general slowdown in underlying earnings growth across a wide range of sectors in January. However, the volatility of monthly earnings data makes it difficult to judge the magnitude of wage adjustment, and therefore data for the next few months are expected to help in more precisely assessing the underlying movements in earnings.

Financial market developments

Except for brief periods, trading conditions in international financial markets have been buoyant since the last interest rate decision. As a result, measures of risk fell and equity indices in developed markets rose significantly, with some of them reaching historical highs. Most of the macroeconomic data released in the US suggested improvement in activity, but in Europe the divergence between the data on economic activity and the forward-looking sentiment indicators remained: while the data on economic growth in Europe were disappointing, business sentiment indices and household confidence indices improved. In addition, uncertainty surrounding the elections in Italy and the future of the financial rescue package for Cyprus led to strains in markets.

The forint weakened by nearly 4% against the euro up to the middle of the period. Then, following a temporary reversal, it depreciated to levels last seen more than a year before after the rating agency Standard and Poor's revised its outlook on Hungary's BB rating from stable to negative and downgraded the credit rating of Cyprus. Non-resident participants increased their short forint positions during the period. Based on both analysts' opinions and measures derived from market prices, there was a downward shift in exchange rate expectations. At the same time, forint demand by domestic participants (mainly exporting companies and households) provided some natural support for the domestic currency, which may have slowed the depreciation of the exchange rate. There were no signs of strain in FX swap market prices.

Perceptions of the risks associated with the Hungarian economy increased significantly over the past month. Hungary's CDS spread rose by nearly 40 basis points to above 350 basis points since the second half of February, while the CDS spreads of other countries in the region stagnated or fell slightly. Spreads on Hungarian foreign currency-denominated bonds also rose markedly, by some 40 basis points, following a temporary decline.

Yields on forint-denominated government paper fell at the short end of the curve, reflecting the market's expectation of a reduction in official interest rates, while those at longer maturities rose by 25–35 basis points, i.e. the slope of the curve steepened. Demand was buoyant at the auctions of government securities in the past month, but non-resident holdings of government paper fell by HUF 40 billion to nearly HUF 4,800 billion.

Expectations of an official interest rate cut in the coming months intensified during the month and the expected interest rate path priced into market rates shifted down, with its bottom falling to around 4.1%.

Position of the banking sector

Movements in the Financial Conditions Index (FCI) suggest that the behaviour of the Hungarian banking sector became less procyclical relative to earlier periods; changes in financial conditions last year did not lead to a further slowdown in the economy. The improvement was mainly related to the decline in interest rates in the course of 2012. It is important to note, however, that base effects, i.e. the high level of interest rates at the end of 2011, also played an important role in explaining the increase in the index.

Outstanding bank lending to the corporate sector fell in February 2013. The decline in foreign currency loans accounted for a major part of the drop in outstanding bank lending. The stock of forint loans virtually stagnated in the month. Average interest rates on forint corporate loans declined further in the first month of the year, while the average interest rate on new loans fell slightly in February.

The stock of bank lending to the household sector also fell in February. This was mainly accounted for by a decline in foreign currency loans, although the stock of forint loans to households also fell. Based on the January data, new bank lending to households continued to be low. The average APRC on housing loans and home equity loans remained broadly unchanged in February.

The stress level in financial markets of key importance in terms of financial stability has barely changed since mid-November, remaining at historically low levels. The Liquidity Stress Index deteriorated slightly in January relative to its level at the end of December. The surplus of banks with liquidity buffers rose further slightly from its previous high levels. The Capital Stress Index, which has been calculated for stress starting from the third quarter of 2012, is significantly below its levels seen last year and remains historically low. Looking forward, however, the maintenance of the bank levy and continued weak profitability pose a risk. Withdrawals of funds, the large stock of non-performing loans, the potentially insufficient coverage for loans as well as low profitability represent key risks to the operation of the domestic banking sector, which in turn may lead to a further reduction in lending.

According to the final January data, the stock of external funds of Hungarian banks operating as companies limited by shares (excluding branches) fell. According to the preliminary data, the outflow of funds then slowed in February. The mild withdrawal of funds was mainly related to parent banks. As expected, the ratio of household loans in arrears of 90 days or more to total loans rose during the fourth quarter. By contrast, the ratio of corporate loans in arrears of 90 days or more fell significantly, mainly as a result of portfolio clean-ups. According to preliminary data, the banking sector's pre-tax profits amounted to HUF 43 billion in the first two months of 2013. The overall capital adequacy ratio remained at appropriate levels across the sector, but showed asymmetry among individual banks.

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

Domestic economic activity had been weaker than expected in recent months, and inflation had fallen sharply in the first months of 2013. Both external and domestic factors had contributed to the decline in GDP towards the end of last year, with temporary cuts in production for idiosyncratic reasons in some sectors of the economy exacerbating the decline. The slowdown in Hungary's export markets had led to a decline in the pace of export growth, while domestic demand, which was of key importance in terms of pricing decisions, continued to be subdued. Council members agreed that the gradual reduction in debt stocks accumulated during the years prior to the crisis, the generally tight credit conditions and the uncertainty surrounding the outlook for activity all pointed to cautious investment and consumption decisions. Taking into account one-off factors significantly affecting some sectors (agriculture, manufacturing) following the deeper-than-expected recession in 2012, the Council expected economic activity to pick up gradually in the coming quarters. Economic growth was likely to resume this year as exports strengthened further, but a recovery in domestic demand and a more balanced structure of growth were only expected from 2014. Corporate investment was also expected to pick up from next year, in line with strengthening economic activity.

The inflation data becoming available around the start of the year indicated a turning point in inflation, supporting the majority view in the Council that subdued demand exerted strong downward pressure on prices, as companies had limited ability to raise consumer prices. Reductions in utilities prices at the start of the year had led to a material slowdown in consumer price inflation. Increases in the prices of non-regulated goods and services had been generally low at the beginning of the year. The annual price index had fallen below the Bank's 3% target by February. Inflation was likely to fall further in the near term, reflecting base effects and the Government's measures aimed at reducing utilities prices. Although the upward impact on costs of the increasing tax burden on certain sectors might pass through to the entire corporate sector along the production chain, which might lead to an increase in core inflation adjusted for indirect taxes, the majority of Council members were of the view that, with the output gap remaining negative, the passing on of higher costs into consumer prices might be slow and partial. As a result of these factors, inflation might remain below the 3% target throughout the year and develop close to the target value in 2014.

Members agreed that there was considerable uncertainty about the macroeconomic outlook and financial market developments. In the Council's judgement, the most important risks were related to the size of spare capacity in the economy as well as future developments in bank lending and risk perceptions. The potential growth rate of the Hungarian economy had slowed substantially during the financial crisis, reflecting the decline in investment and the financing constraints, but there was significant uncertainty about the amount of productive capacity lost. If productive capacity had been damaged only to a smaller extent, then the cyclical position of the economy might be wider. With a wider cyclical position, the ability of companies to pass on cost shocks into prices was more limited and the inflationary impact of cost shocks to companies was smaller, which, in turn, warranted an additional easing of policy. For the majority of members, the outlook for inflation and growth made it possible to ease monetary conditions. However, some decision-makers noted that low economic growth reflected structural factors, which could not be addressed by policy easing, and instead other economic policy responses were required.

Decision-makers agreed that developments in lending would have a strong impact on the speed of recovery from the recession. The Council's past interest rate reductions had led to lower lending rates, but it was difficult to judge precisely the extent to which this would stimulate lending. If lower lending rates provided stimulus to investment and bolstered household consumption through a pick-up in lending, the recovery of the economy from the crisis might be faster.

Changes in risk perceptions might materially influence the room for manoeuvre in monetary policy. Volatility in the financial market environment had increased in recent months following the marked improvement last year. In the continued benign external market environment, premia on domestic financial assets had remained broadly stable until February, before increasing in March. In the Council's judgement, if the dichotomy between benign global financial market conditions and weak real economic performance was not resolved on a sustained basis despite the significant crisis management efforts by European institutions, it would pose a risk. If there was a significant reduction in global risk appetite, risk premia on domestic financial assets might rise significantly. Members' views differed on the recent depreciation and increased volatility of the forint exchange rate. The majority of decision-makers judged that this mainly reflected the events in Cyprus, uncertainty in relation to the change in the Bank's management and the credit rating downgrade by S&P. By contrast, some members of the Council thought that further policy easing expected and priced in by the market had also played a role. In their judgement, the current level and increased volatility of the exchange rate, as well as recent developments in the government securities market warranted a cautious, wait-and-see approach to policy.

After the discussion, the Chairman invited members to vote on the proposals put to the Council. Seven members voted to reduce the Bank's policy rate by 25 basis points and two members voted to maintain it. In terms of future monetary policy decisions, members agreed that the Council would only consider a further reduction in the policy rate if medium-term inflationary pressures remained moderate and the uncertainty surrounding financial market developments diminished.

Votes cast by individual members of the Council

In favour of reducing the base rate to 5.00%	**7**	Ádám Balog, Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, György Kocziszky, György Matolcsy, Gyula Pleschinger
In favour of maintaining the base rate at 5.25%	**2**	Ferenc Karvalits, Júlia Király

The following members of the Council were present at the meeting:

Ádám Balog
Andrea Bártfai-Mager
János Cinkotai
Ferenc Gerhardt
Ferenc Karvalits
Júlia Király
György Kocziszky
György Matolcsy
Gyula Pleschinger

The Council will hold its next policy meeting on 23 April 2013. The minutes of that meeting will be published at 2 p.m. on 15 May 2013.