MAGYAR NEMZETI BANK

# MINUTES

## OF THE MONETARY COUNCIL MEETING

## 23 APRIL 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 data on inflation and wages released over the past month suggest that subdued domestic demand and the loose labour market continue to have a strong influence on companies' pricing and wage-setting decisions. In the short term, the rates of increase of prices and wages may be more modest than projected in the Bank's March *Quarterly Report on Inflation*.

The annual rate of consumer price inflation was 2.2% in March, its lowest level since the political transition. The core inflation measure, adjusted for indirect taxes, remained unchanged at 1.7%. Measures capturing the medium-term outlook for inflation remained at the low levels observed since the beginning of the year. Developments in market services prices, which are closely monitored by monetary policy, continued to be moderate, with the annual index, adjusted for indirect taxes, remaining at historically low levels. The March inflation figure fell short of the expectations, mainly reflecting the lower-than-expected contribution of food prices. The incoming data support the view that weak domestic demand is limiting the ability of companies to pass cost increases through into consumer prices. The March inflation data, the stronger EUR/HUF exchange rate and lower crude oil prices suggest that inflationary pressures will continue to ease.

Based on the January–February wage data, private sector companies may have strongly limited pay increases this year. In February, private sector gross average earnings grew by only 1.2%. Measures of regular pay and underlying earnings growth confirm that the rate of earnings growth is slowing quite sharply. However, wage data for March are expected to provide guidance on the likely path of annual earnings growth, as the majority of companies will report on their usual annual pay increases during that month.

Industrial and foreign trade data confirmed that significant transient factors played a role in the performance of industry at the end of last year. Their impact was reversed at the beginning of 2013. Although industrial production fell by 5.4% in February relative to a year earlier, the January–February average of (seasonally adjusted) industrial production was 1.5% higher than the monthly average level of output in the fourth quarter of 2012. Underlying developments in Hungarian exports continue to be determined by slack demand in the country's export markets, but the confidence indicators suggest some improvement looking forward.

Subdued domestic demand has played a key role in the recent moderation in inflation. Retail sales, including sales of vehicles and parts, declined by 2.3% in January relative to a year earlier. According to preliminary February data, retail sales excluding sales of vehicles and parts was 1.4% lower than in the same period of the previous year. The trend measures of retail sales suggest that the rate of decline in sales slowed relative to previous months. Developments in net real wages and household confidence indicators point to a stabilisation of household consumption throughout the latter part of the year, in line with the March projection.

Construction output rose by 7.2% in February relative a year earlier, with the low base and better-than-usual weather conditions playing a role. Existing contracts for construction were 17.6% higher than in February 2012, which may point to an increase in infrastructure investment projects financed from EU funds.

## Financial market developments

Sentiment remained strong in global financial markets in the period after the Council's policy decision in March. In part, this reflected the improvement in the situation in Cyprus, further monetary stimulus by developed country central banks and another round of quantitative easing in Japan. In the second half of the month, however, global risk appetite weakened slightly, mainly due to the release of some weaker-than-expected macroeconomic data.

Prices of risky assets moved in opposite directions during the month. While equity indices in the US and Japan rose, those in Europe and China fell. In the benign international environment at the beginning of the period, the VIX index remained at low levels, but then began rising in the second half of the period. Conditions in commodity markets were very turbulent, leading to falls in the prices of gold, silver and oil.

Uncertainty about the euro-area economy has fallen in the past month, as reflected in the sharp declines in yields on Portuguese, Spanish and Italian ten-year government bonds. In addition, long-term yields in Slovenia and Cyprus also fell markedly, although they remained above the levels seen in early March.

Movements in exchange rates of developed country currencies lacked a clear direction, except for the Japanese yen, which depreciated further due to the quantitative easing policy by the Bank of Japan.

Sentiment in domestic financial markets has also been favourable since the Council's last interest rate decision. Domestic events greatly contributed to this, in addition to the positive mood in global markets. Apart from minor fluctuations, the forint appreciated against the euro in the past month and clearly outperformed other currencies of the CEE region. Expectations of the forint's future value shifted towards appreciation in the second half of the period.

Most of the temporary rise in the Hungarian CDS premium at the beginning of the month was reversed during the latter part of the period, with the five-year premium falling rapidly to levels close to 300 basis points.

Yields on forint-denominated government securities also fell sharply, reaching historical lows at most maturities. In addition to the positive global sentiment, heightened expectations of a further interest rate cut at the short end and the decline in the country risk premium at the long end of the curve may have also contributed to the fall in yields.

There continued to be no signs of strain in the FX swap market. Following some sharp rises at the end of the quarter, which were related to balance sheet adjustment by some non-resident participants, swap spreads fell markedly at almost every maturity. Spreads fell particularly sharply at long maturities.

Short-term interest rate expectations were broadly unchanged, with the market continuing to expect the Monetary Council to reduce interest rates in steps of 25 basis points at its forthcoming meetings. However, the interest rate path derived from implied rates moved down further to 3.75%.

## Position of the banking sector

The negative value for the Bank's Financial Conditions Index (FCI) in the first quarter of 2013 once again suggests that the change in financial conditions continued to act as a drag on the economy. Although there was an improvement towards the end of 2012, the depreciation of the exchange rate and the levels of interest margins on lending outweighed the positive contribution from interest rate cuts in the first quarter of 2013. As a result, it still appears that financial conditions in general and the supply of bank credit are continuing to delay the closure of the output gap.

In February, outstanding lending to the corporate sector fell significantly, dropping by HUF 86 billion. The fall in forint loans, and short-term loans in particular, accounted for a major part of this decline. By contrast, the stock of foreign currency lending rose slightly. Average interest rates on forint corporate loans declined further in February. The average interest rate on new loans fell by 10–20 basis points relative to the previous month. Over the period since the end of August, the average interest rate has fallen by a total of 1.5%–2.0%.

The stock of bank lending to the household sector fell by a total of HUF 47 billion in the month. That fall was similar in size and composition to those in previous months. The drop in foreign currency loans accounted for HUF 33 billion of the total decline in the stock of loans. Based on the February data, new bank lending to households remained low. The average interest rate on housing loans remained broadly unchanged, in contrast with that on home equity loans, which rose slightly in February.

Following a temporary increase, in March the System-Wide Financial Stress Index (SWFSI), a measure of the level of stress from the sub-markets of key importance for financial stability, returned to the historically low levels of previous months.

The Liquidity Stress Index did not change materially in March relative to its level in the previous month. Banks would meet the regulatory requirements even under stress. Although the surplus of banks with liquidity buffers fell, their liquidity position continued to be adequate.

The ratio of non-performing loans to total lending to the household sector increased during the fourth quarter of 2012, in line with expectations. The modest rise in payment defaults was accompanied by a slight increase in total coverage for loans. In the corporate sector, the ratio of loans overdue for 90 days or more fell significantly, mainly as a result of intense portfolio cleaning. Contrary to expectations, however, the value for the portfolio cleaning component was negative for the first time since the beginning of the crisis, i.e. the stock of non-performing loans would have fallen even in the absence of portfolio cleaning.

According to the preliminary results, there was an increase in the Solvency Stress Index (SSI), which was calculated for a stress scenario beginning in the first quarter of 2013 over a two-year horizon. This reflected the worse initial capital position, on the one hand, and the weaker earnings outlook due to last year's weak profits, on the other. Another factor explaining the rise in the Index is that three large banks have a relatively small shortage of capital.

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

In the Council's judgement, Hungarian economic growth was likely to resume this year following last year's recession, while at the same time both external and domestic demand pointed to only modest growth. The level of output remained below its potential and unemployment above its long-term level determined by structural factors. The Council expected weak demand conditions to persist, ensuring that inflationary pressures in the economy remained low in the period ahead.

The recent inflation data had reinforced the Council's view that weak domestic demand was exerting strong downward pressure on prices. Inflation had fallen back to below the Bank's target, reflecting the effects of the reduction in administered prices at the beginning of the year and subdued demand. The upward impact on costs of fiscal measures, leading to a higher tax burden on certain sectors of the economy, might feed through gradually to the entire corporate sector along the production chain, which in turn might lead to higher core inflation adjusted for indirect taxes. However, the Council judged that, with the output gap remaining negative, the passing on of increased costs into consumer prices might be slow and partial. Inflation was likely to remain below the 3 per cent target throughout this year and to settle in close to the target value in 2014.

External and domestic factors had both contributed to weak activity data towards the end of last year, while temporary cuts in production in some sectors of the economy for idiosyncratic reasons had exacerbated the downturn. Growth was expected to resume this year as the country's export markets improved, but external and, to a greater extent, domestic demand factors pointed to only modest growth in the period ahead.

In the low inflation environment, household real income growth was likely to recover. However, earnings data becoming available in recent months reinforced the Council's view that regular earnings and measures of underlying wage growth suggested a marked slowdown in the rate of earnings growth, which might further reduce inflationary pressures in the period ahead.

Due to the protracted deleveraging process and increased uncertainty about the economic environment, however, household consumption behaviour was likely to be cautious and the saving rate to be high, and therefore consumer demand was likely to strengthen only from 2014.

Global risk appetite had remained high over the past month. Risk premia on Hungarian financial assets had fallen significantly, reflecting an improvement in the international environment. Council members agreed that Hungary's financial stability was adequate. The country's risk premium had fallen substantially and both short and long-term government securities yields declined significantly, reaching historically low levels. The forint had appreciated steadily against the euro, apart from relatively small shifts. The Hungarian CDS spread had also fallen sharply in the past month.

In the Council's judgement, however, the contrast between the benign financial market environment and weak real economic activity still remained, despite intensified efforts by the international community, which warranted a cautious approach to policy.

In the Council's judgement, the economic data becoming available in the past month suggested that weak demand continued to exert a strong disinflationary impact on prices, and therefore companies had limited ability to pass on higher production costs into prices. Based on this assessment, the outlook for inflation and the real economy was consistent with a lower central bank base rate.

After the discussion, the presiding Chair invited members to vote and the Council made a unanimous decision to reduce the central bank base rate by 25 basis points. In terms of future monetary policy decisions, members agreed that the Council would only consider a further reduction in the policy rate if the medium-term outlook for inflation remained in line with the Bank's 3 per cent target and the improvement in financial market sentiment was sustained.

**Votes cast by individual members of the Council**

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| **In favour of reducing the base rate to 4.75%** | **5** | Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, György Kocziszky, Gyula Pleschinger |

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

Andrea Bártfai-Mager
János Cinkotai
Ferenc Gerhardt
György Kocziszky
Gyula Pleschinger

Dániel Palotai, Executive Director

**The Council will hold its next policy meeting on 28 May 2013. The minutes of that meeting will be published at 2 p.m. on 12 June 2013.**