MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

28 MAY 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

In April, the consumer price index fell to 1.7%, and indirect tax-adjusted core inflation stood at 1.6%. Measures capturing the medium-term outlook for inflation were practically unchanged relative to the previous month, remaining at the low levels seen at the beginning of the year. The historically low rate of services inflation reflected the downward effect on prices of subdued domestic demand. The latest available data indicate that depressed demand is limiting the ability of companies to pass cost increases through to consumer prices. Overall, the April inflation data point to lower inflation in the period ahead.

According to the preliminary release, Hungary's GDP expanded in the first three months of 2013 relative to the previous quarter. This can be interpreted as a partial correction of the decline registered in the final quarter of 2012, in line with expectations. On the output side, the unwinding of one-off effects may have been reflected in both industry and agriculture. In respect of sectors producing for the domestic market, construction output rose at the beginning of the year and, according to the most recent data, the pace of decline in retail sales may have slowed. On the expenditure side, the contribution of net exports to growth may have remained positive, and household consumption may have contracted at a slower pace than previously. Following the unwinding of one-off factors, the rate of GDP growth is likely to be determined by underlying developments in the economy.

After picking up in January, industrial production generally stagnated as the temporary factors contributing to the decline at the end of last year dissipated. In March, industrial production fell by 2.9% relative to a year earlier, but rose relative to the previous quarter. The main underlying factors driving industrial production did not improve in the previous months, and based on the latest available indicators, neither domestic nor external factors are making any material contributions to industrial production growth.

The downward pressure on prices from subdued domestic demand is an important factor behind the recent moderation in underlying inflation. Real earnings stabilised at the beginning of this year, and household confidence indicators point towards some improvement in prospects. Nevertheless, household consumption is likely to be driven by precautionary motives, suggesting modest consumption growth even as the sector's income position improves.

Private sector earnings growth was subdued in the first quarter, in line with continued loose labour market conditions. Gross average earnings in the private sector grew by 2.7% in March 2013 relative to a year earlier. The data suggest that, apart from the wage raises resulting from the increase in the statutory minimum wage, companies did not raise wages significantly in higher income brackets. Underlying private sector earnings growth was moderate in the first quarter, which was consistent with the low inflation environment.

In March, construction output rose by 9.9% year on year, partly reflecting base effects. The volume of existing contracts for construction was 19.6% higher in March than twelve months earlier, reflecting an increase in infrastructure investment projects financed from EU funds. Dwelling construction continued to be weak.

Financial market developments

Sentiment in global financial markets has continued to improve since the Council's policy decision in April. Measures of risk appetite were near levels seen prior to the crisis. The markets' optimism mainly reflects the quantitative easing policies of developed country central banks: although investors are focussing on the possibility that the Fed might soon start winding down its asset purchase programme (QE3), the Bank of Japan's large extension of its asset purchase programme has given new impetus to markets. However, data on the real economy vary widely across regions and only provide partial explanation for strong market sentiment in money and capital markets. This highlights the uncertainties surrounding future developments in financial markets.

The major equity indices in developed markets have continued to rise, with both the S&P and DAX indices reaching historical highs. In addition, markets in Japan rose particularly sharply. By contrast, the performance of emerging markets was mixed: while markets in Asia and Central and Eastern Europe rose modestly, equity indices in Latin America remained fairly flat.

Tensions in the euro-area periphery also eased: the stabilisation of the domestic political environment in Italy, the upgrading of Greek debt and the successful ten-year bond issue in Portugal all pointed to an improvement, while the downgrading of Slovenia's debt had no material impact on developments. Strong global sentiment significantly influenced the securities markets: long-term yields in the euro-area periphery countries fell amidst extreme volatility. Short-term government bond yields declined moderately, while long-term yields fell sharply in the emerging countries of the region. In line with this, yields on safe haven assets rose.

Movements in foreign exchange markets were volatile: rumours about the winding down of QE caused the US dollar to appreciate against most major currencies. Among the currencies of the CEE region, the Romanian leu remained broadly unchanged, while the Polish zloty and the Czech koruna weakened against the euro.

Sentiment in domestic financial markets has remained positive since the Council's last interest rate decision. The forint appreciated against the euro almost without interruption over the entire month, outperforming other currencies of the region. There was an upward shift in exchange rate expectations, as suggested by the decline in the skewness measure of expectations and the increase in non-residents' long forint positions. Furthermore, residents' outstanding forward contracts also declined sharply.

In the FX swap market, trading was smooth following the reversal of the rise in implied forint yields at the beginning of the period. The decline in long-term swap spreads reflected the improvement in perceptions of the risks associated with the Hungarian economy. The five-year CDS spread fell to 275 basis points from 300 basis points at the beginning of the period, and this fall was larger than the declines in spreads in other countries of the region. The conclusions that can be drawn from the Bank's method of decomposing CDS spreads are consistent with this: country-specific factors and international influences accounted for two-thirds and one-third, respectively, of the fall in the Hungarian CDS spread.

Demand for discount Treasury bills was weak, whereas robust demand for long-term government bonds was registered at the auctions of government paper held in the month. Nevertheless, benchmark government securities yields fell sharply, with most of them reaching historical lows.

Position of the banking sector

The negative value for the MNB'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.

Outstanding lending to the corporate sector fell sharply in April, declining by a total of HUF 71 billion. As seen in the previous month, the fall in forint loans accounted for the bulk of this decline. Average interest rates on small-value forint corporate loans declined further in March, while those on loans of over the equivalent of EUR 1 million rose, owing to one-off effects.

The stock of bank lending to the household sector continued to fall in April. The decline amounted to of HUF 41 billion in the month, with the changes in the stocks of both forint and foreign currency loans being average.

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. During this temporary increase, the value of the Index did not approach the danger zone. The Liquidity Stress Index remained broadly unchanged in April compared to the previous month. Banks would meet the regulatory requirements even under stress, suggesting that their liquidity position continues to be adequate.

The ratio of non-performing loans to total lending to the household sector increased significantly, to 17.9% during the first quarter. The affiliation of Erste's leasing company contributed significantly to this sharp increase. In the corporate sector, the ratio of loans overdue for 90 days or more remained unchanged.

According to preliminary data, the banking sector's pre-tax profits amounted to HUF 92 billion in the first four months of 2013. This was accounted for in large part by one bank. Of the large banks, four posted losses, with only two managing to record a profit. The capital adequacy ratio continued to be adequate at the system level, but there was a heterogeneity across banks.

According to the preliminary results, there was an increase in the Solvency Stress Index, which was calculated for a stress scenario beginning in the first quarter of 2013 over a two-year horizon. There were several reasons for this. First, the initial capital position was worse. Second, the earnings outlook was weaker, due to last year's weak profits. Another factor explaining the rise in the Index is that three large banks may have a relatively small shortage of capital. Overall, the sector's additional capital needs under stress are less than HUF 70 billion, i.e. they remain manageable.

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 was higher than 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.

Inflation had slowed sharply in April, partly related to developments in the prices of non-core items. Recent trends in underlying inflation continued to reflect the strong downward pressure of weak domestic demand on prices. The subdued rate of earnings growth suggested that companies were adjusting through the labour market more strongly in response to the increase in production costs, and therefore the pass-through into consumer prices was likely to be moderate. Recent developments in energy and commodity prices as well as the forint exchange rate had also contributed to the disinflation process. These factors reinforced the Council's view that inflation would remain persistently below the 3% target and inflationary pressures would remain moderate in the medium term.

Members agreed that, based on the preliminary data, the Hungarian economy might recover from recession in the first half of 2013. The correction of adverse one-off shocks at the end of last year may also have contributed significantly to the strong quarter-on-quarter growth. The main underlying factors driving growth had not changed significantly: the outlook for global growth remained weak, while precautionary motives continued to be a drag on the recovery in domestic demand. A sustained pick-up in growth was likely to occur from the end of the year as demand in Hungary's export markets improved.

Risk appetite in global financial markets had remained strong in the past month. In this supportive environment, domestic indicators of risk had fallen further. The Council judged, however, that the contrast between the benign financial market environment and the weak outlook for global growth continued to pose a risk, which called for maintaining a cautious approach to policy.

In the Council's judgement, the economic data becoming available in the month reinforced the view that weak demand continued to exert a strong disinflationary impact on prices, and therefore companies had limited ability to pass cost increases through to consumer prices, while they were making stronger adjustment through the labour market.

Council members therefore agreed that the outlook for inflation and the real economy was consistent with a lower central bank base rate.

After the discussion, the Chairman 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

In favour of reducing the base rate to 4.50%	**7**	Ádám Balog, Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, György Kocziszky, György Matolcsy, Gyula Pleschinger

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

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

The Council will hold its next policy meeting on 25 June 2013. The minutes of that meeting will be published at 2 p.m. on 10 July 2013.