MINUTES
OF THE MONETARY COUNCIL MEETING
23 JULY 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

Domestic inflation remains at historically low levels, continuing the trend seen in earlier months. In June, the consumer price index stood at 1.9% and core inflation at 3.0%. The annual rate of consumer price inflation rose by 0.1 percentage point and that of core inflation by 0.3 percentage points relative to the previous month. Core inflation, adjusted for indirect taxes, was 1.5% in July. The measures providing an indicator of the medium-term outlook for inflation fell slightly relative to the previous month and have remained at low levels since the beginning of the year, taking the average of the past several months.

Relative to a year earlier, industrial production fell by 2.1% in May. Output declined in a wide range of sectors. Of the main industry groups within manufacturing, output grew only in the food industry. Within machinery and equipment, vehicle production stagnated in May and the output of the electronic sector fell. Industrial sales continue to reflect the contrast between domestic and external demand growth: domestic sales have been declining and exports have remained broadly flat. Of the forward-looking indicators measuring activity, recent data on orders suggest a weaker outlook, while some confidence indicators suggest an improving outlook for the coming months.

The trade surplus fell relative to the previous month, but grew in the first five months of the year relative to same period of 2012. The improvement in Hungary's terms of trade also contributed to the increase in the goods surplus, in addition to rising export volumes.

In April, the volume of retail sales was 0.1% higher than twelve months previously. Monthly trend indicators point to a modest increase in sales volumes. Real earnings, one of the most important macroeconomic factors of household consumption, rose slightly in April, and the household confidence index continued to indicate an improvement in the outlook for consumption. By contrast, borrowing for consumption continued to fall. Accompanied by ongoing deleveraging and tight credit conditions, households' consumption behaviour remained cautious.

According to seasonally unadjusted data, construction output grew at an annual rate of 11.2% in May 2013. The volume of existing contracts for construction was 10.4% higher at the end of month than a year earlier. The May increase in the sector's output may have reflected an increase in the Government's infrastructure investment projects financed from EU funds, in addition to the very low base of 2012.

Labour market data which have become available in the past month reinforce the view that companies are seeking to restrain wage costs in order to restore profitability. Growth in the private sector wage index was subdued in May, as seen in the first few months of the year. The differences across sectors seen in April remained, with earnings growth continuing to be fairly strong only in manufacturing. According to the results of the May Labour Force Survey, the number of people in employment in the whole economy continued to rise. However, developments in vacancies suggest that this mainly reflects an increase in the number of public workers. Consequently, private sector employment may have made little contribution to the increase in whole-economy employment.

Financial market developments

On balance, sentiment in global financial markets has been buoyant since the Council's last interest rate decision, despite weakening on several occasions. Indicators of risk appetite improved markedly, with developed-country equity indices rising sharply and currencies of the region appreciating. At the same time, however, negative news about interbank tensions in China and the outlook for growth of the Chinese economy led to a temporary deterioration in sentiment during the month. The government crisis in Portugal, the rating downgrade of Cyprus to a level indicating selective default and concerns over financial assistance to Greece also led to higher risk aversion. However, announcements by the US Fed to calm the markets as well as forward guidance by the ECB and the Bank of England were successful in improving investor sentiment.

Expectations about the future of the Fed's asset purchase programme continued to be the main factor influencing global financial market developments. The minutes of the latest Board of Governors meeting did little to alter the broad picture about the possible phasing-out of the programme.

The above developments significantly influenced developments in government securities yields: yields on ten-year US and German government bonds rose sharply by early July, before reversing slightly in response to statements intended to calm markets. Yields on bonds in countries of the euro-area periphery mainly responded to negative news from the euro area. Ten-year yields in Portugal rose by 30 basis points and those in Spain and Italy fell by 35–40 basis points.

In Hungary, developments in every partial market have been favourable since the Monetary Council's last interest rate decision, mainly reflecting the improvement in sentiment in international financial markets. Some domestic indicators performed relatively well or outperformed indicators in the rest of the region, suggesting that country-specific factors may also have contributed to the improvement, in addition to the reversal of the spike in global risk aversion from June.

The forint appreciated in two waves against the euro, by a total of 1%, performing broadly similarly to other currencies of the Central and Eastern European region. Another positive sign was the fact that options quotes for the forint indicated diminishing expectations of forint depreciation.

There has been an improvement in perceptions of the risks associated with the economy since the Council's last interest rate decision, as reflected in movements in yields on Hungarian government securities. The Hungarian five-year CDS spread fell from 340 basis points at the beginning of the period to around 290 basis points, and the spread on the five-year euro-denominated bond fell by 30 basis points. Government securities yields in the narrowly-defined Central and Eastern European region fell by a similar amount.

Benchmark yields on domestic government securities also fell as perceptions of the risks associated with the Hungarian economy improved. Despite the withdrawal of capital from the emerging markets, during the past four weeks non-resident holdings of forint-denominated government securities rose to a level close to HUF 5,200 billion, marking an all-time high.

Position of the banking sector

The negative value for the MNB's Financial Conditions Index (FCI), calculated using preliminary data for the second quarter of 2013, once again suggests that financial conditions continue to act as a drag on economic growth. There was an improvement in the second quarter following the deterioration in the first quarter of 2013, but the index nevertheless remained in negative territory.

Outstanding bank lending to the corporate sector fell again in June following the increase in May, declining by a total of HUF 56 billion. Forint loans accounted for the major part of the fall in the stock of lending. By contrast, outstanding foreign currency lending rose in the month. In May, average interest rates on new small and large-value forint corporate loans as well as on loans of over the equivalent of EUR 1 million fell slightly.

The stock of bank lending to the household sector continued to fall in June. The decline amounted to some HUF 40 billion, broadly the same as in the previous month, with foreign currency loans accounting for the larger part of the fall. The stock of forint lending also fell slightly in the month. Average interest rates on new lending to the household sector continued to follow the decline in interbank interest rates.

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 earlier levels following the slight increase in the previous month and remained at a distance from the danger zone.

The Liquidity Stress Index rose modestly in June relative to the previous month. Banks would meet the regulatory requirements even under stress. Overall, their liquidity position continues to be adequate. The combined stress test is based on the exchange rate prevailing at the end of June; consequently, the stress exchange rate assuming a 15% depreciation corresponds to an exchange rate of EUR/HUF 339.

Based on preliminary data, the banking sector's pre-tax profits amounted to HUF 73 billion in the first half of 2013. This was accounted for in large part by one bank. Of the large banks, four posted losses, with only three managing to record a profit. The twelve-month rolling ROE stands at -1%.

The capital adequacy ratio continued to be adequate at the system level, but there was heterogeneity across banks. The ratio stood at 16.7% at the end of March following a significant increase. The Solvency Stress Index, which was calculated for a stress scenario beginning in the first quarter of 2013 over a two-year horizon and published in the *Report on Financial Stability*, indicated a higher value relative to the previous period. 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 increase is that three large banks have a shortage of capital, which, however, is relatively small. Overall, the sector's additional capital needs under stress amount to less than HUF 70 billion, i.e. they remain manageable. Looking ahead, weak profitability poses a risk, mainly reflecting the bank levy, credit losses and weak bank lending activity.

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. However, the level of output remained below its potential and unemployment exceeded its long-term level determined by structural factors. The Council expected weak demand conditions to persist, which would ensure that inflationary pressures in the economy remained muted in the period ahead.

Inflation remained low in June. The historically low rate of inflation was partly related to developments in the prices of non-core items. In addition, measures of underlying inflation had fallen further and had been at low levels since the beginning of the year, reflecting the strong downward pressure of weak domestic demand on prices. The low rate of earnings growth suggested that companies were adjusting to higher production costs mainly through labour costs, and therefore the pass-through into consumer prices was likely to be moderate. In the Council's judgement, these factors indicated that underlying inflation remained subdued and risks to inflation would be moderate over the medium term.

The Hungarian economy was likely to recover from recession in 2013. 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. The external balance of the economy remained favourable.

In the Council's view, risk appetite in global financial markets had been highly volatile over the past month. Domestic indicators of risk had declined despite increased uncertainty in the global financial environment, and no significant sell-off of domestic assets had occurred. Some members were of the view that this had been a significant and favourable change relative to earlier trends, but they pointed out that in a number of cases withdrawals of capital from emerging markets had reflected country-specific factors. In the Council's assessment, increased volatility in sentiment in global financial markets and the uncertain outlook for global economic growth continued to pose a risk, which in turn called for maintaining a cautious approach to policy.

In the Council's judgement, there was a significant degree of spare capacity in the Hungarian economy and inflationary pressures were likely to remain moderate even over the medium term. Data becoming available over the past month confirmed that weak demand was exerting a strong disinflationary impact, and therefore companies had limited ability to pass on higher production costs into prices. Consequently, a more accommodating monetary policy would ensure that the 3% inflation target was achieved. However, global financial markets had been volatile recently. Any sustained, marked shift in perceptions of the risks associated with the economy could influence the room for manoeuvre in monetary policy.

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 the Council's judgement, the significant reductions in interest rates so far and the volatile conditions in financial markets might justify changing the pace or extent of policy easing over the coming months. Members agreed that it would be appropriate to send a signal to market participants about expected changes to the future conduct of interest rate policy.

Votes cast by individual members of the Council

In favour of reducing the base rate to 4.00%	**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 27 August 2013. The minutes of that meeting will be published at 2 p.m. on 12 September 2013.