MINUTES

OF THE MONETARY COUNCIL MEETING

24 JUNE 2014

Article 3 (1) of the MNB Act (Act CXXXIX of 2013 on the Magyar Nemzeti Bank) 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 present the decision-makers' assessment of current economic conditions and the factors they consider when deciding on the base rate. Until December 2013, the Monetary Council presented the information underlying its assessments as part of the abridged minutes. In order to provide more detailed information, background materials will henceforth appear as a separate publication with enhanced content under the title 'Macroeconomic and financial market developments', at the same time as the abridged minutes.

The minutes are available on the MNB's website at:
http://english.mnb.hu/Monetaris_politika/decision-making/mnben_mt_jegyzokonyv

THE COUNCIL'S ASSESSMENT OF CURRENT ECONOMIC CONDITIONS AND THE INTEREST RATE DECISION

In the Council's judgement, reductions in the base rate since August 2012 had been justified by the low inflation environment, subdued medium-term inflationary pressures and a degree of spare capacity in the economy. Risk perceptions associated with the economy had also been generally supportive. The significant easing of monetary policy implemented so far had helped the Bank achieve the inflation target in the medium term and had contributed to the strengthening of domestic economic growth. The Council's aim was still to maintain a balanced and conservative approach to policy. In addition to the primary goal of meeting the inflation target, the Council also took into account the condition of the real economy and incorporated financial stability considerations into its decisions.

In the Council's judgement, inflation was likely to remain low for an extended period and to reach levels around 3 per cent consistent with price stability only at the forecast horizon. Inflation was likely to remain well below the 3 per cent target in 2014, before moving into line with the medium-term inflation target from the second half of 2015. The dynamics of consumer price inflation had been historically low in recent months. Subdued inflation in external markets, the degree of unused capacity in the economy, moderate wage growth, the fall in inflation expectations and the reductions in regulated prices, implemented in a series of steps, had all contributed to the development of a low inflation environment. At the forecast horizon, the domestic real economic environment was expected to continue to have a disinflationary impact, although to a declining extent. Persistently low inflation alongside rising domestic demand reflected mainly the impact of moderate wage growth due to continued slack in the labour market and other supply-side cost shocks. The persistently low inflation environment was expected to help anchor inflation expectations playing a key role in determining the nominal path of the economy more firmly around the Bank's inflation target.

Several Council members noted that, consistent with the projection in the June issue of the *Inflation Report*, there remained room for further cautious easing of monetary policy, without jeopardising financial stability. In addition, several decision-makers indicated that the easing cycle might be nearing its end, but the macroeconomic outlook pointed in the direction of persistently loose monetary conditions. One member commented that price stability has already been achieved and inflation over the forecast horizon is expected to be in line with the inflation target set out based on the MNB Act. Moreover, further policy easing is not warranted, and it would only facilitate economic growth to a barely perceptible degree. The economic growth could be just as well facilitated with unconventional central bank instruments, namely, the Funding for Growth Scheme. The same member then added that, if investor sentiment were to change, further easing of monetary policy could pose financial risks, whereas its positive impacts would be limited. By contrast, another member noted that the recent cautious interest rate reductions had had a positive impact on the economy.

Economic activity had picked up gradually in the past quarters, with output rising across a wide range of sectors. Looking ahead, Hungarian economic growth might continue in a more balanced pattern than previously. Rising exports were likely to play an important role as a source of growth in the coming years as well. In addition, domestic demand was also expected to strengthen further. Investment was likely to continue accelerating, reflecting the improvement in the outlook for activity, the easing in credit constraints also due to the Bank's Funding for Growth Scheme and the increasing use of EU funding. Household consumption was also likely to grow gradually, resulting from the expected increase in the real value of disposable income and the reduced need for deleveraging. Meanwhile, the behaviour of a large number of households continued to be influenced by the ongoing reduction in debts accumulated in the years prior to the crisis and the gradual easing in credit conditions. As a result, propensity to save was likely to remain persistently above levels seen in the period prior to the crisis. Despite the pick-up in domestic demand, capacity utilisation was expected to improve only gradually due to the protracted recovery in Hungary's export markets.

One decision-maker noted that favourable financing conditions were required in order to expand the productive capacity of the economy, which in turn justified accommodative monetary policy over the longer term. Another decision-maker judged that further growth in investment would require an increase in the stock of orders. In the absence of such an improvement, it seemed unlikely that low lending rates would be able to significantly boost demand for credit.

The external position of the economy had continued to improve towards the end of 2013, as reflected in the significant decline in external debt ratios. The trade surplus, while remaining substantial in the coming years even as import picked up due to increasing consumption and investment, was likely to keep the current account surplus high over the entire forecast period. The slight decline in the income balance deficit was expected to contribute to Hungary's external position remaining strong. On balance, the external financing capacity of the economy was likely to remain high despite the slight fall in EU transfers due the new budget cycle. In line with this, the country's debt ratios, key indicators in terms of the country's vulnerability, were likely to continue to improve. At the same time, the Bank's self-financing programme was expected to help reduce the country's gross external debt.

International investor sentiment had been volatile in the past quarter, mainly reflecting the reduction in the pace of the Fed's asset purchases, the ECB's interest rate cut and announced new package of policy measures and the continuation of the conflict between Ukraine and Russia. Domestic risk premia had fallen significantly in the period since publication of the March *Report*. The CDS spread, foreign currency bond spreads and long-term yields had declined. The exchange rate had appreciated. The volatility of the major risk indicators had fallen relative to the previous quarter. The announcement of the Bank's self-financing concept had also contributed to the improvement in risk perceptions associated with the economy. Compared with other emerging market economies, Hungary's persistently high external financing capacity and the resulting decline in external debt contributed significantly to the reduction in its vulnerability. The Monetary Council would continue to closely monitor developments in the global financial environment.

In connection with the baseline projection in the June *Report*, the Monetary Council had identified three alternative scenarios which might significantly influence the future conduct of monetary policy. In the alternative scenario assuming a persistently low external inflation environment and a slower-than-expected recovery in external demand, the inflation target might be achieved with looser monetary conditions than assumed in the baseline scenario. In the risk scenario assuming an unfavourable external environment and higher investor risk aversion, inflation moved in line with price stability in the medium term under considerably tighter monetary conditions than implied by the baseline projection. A third scenario, assuming a pick-up in domestic employment and consumption and, consequently, strongergrowth in domestic activity, also implied a tighter monetary policy stance.

After reviewing the projection in the June *Report*, the Council judged that there remained a degree of unused capacity in the economy and inflationary pressures in the economy were likely to remain moderate for an extended period. The negative output gap was expected to close gradually at the monetary policy horizon; however, achieving price stability in the medium term pointed in the direction of monetary easing and the macroeconomic outlook pointed in the direction of persistently loose monetary conditions.

After the discussion, the Chairman invited members to vote on the propositions. Seven members voted in favour of a 10 basis point reduction and one member voted for maintaining the base rate. Several members noted that the current 10 basis point reduction in the base rate was consistent with the June inflation projection, and therefore that action might further strengthens the Bank's credibility. One member, however, thought that that the bottom of the interest rate cycle had been reached and, accordingly, price stability could be ensured by maintaining the base rate at 2.4%.

The majority of Council members thought that, considering the outlook for inflation and taking into account perceptions of the risks associated with the economy and the pick-up in economic growth, further cautious easing of monetary policy might follow; however, based on available information the central bank base rate had significantly approached a level which ensured the medium-term achievement of price stability and a corresponding degree of support for the economy. Over the coming period, changes in the domestic and international environment might influence this picture.

Votes cast by individual members of the Council

In favour of reducing the base rate to 2.30%	**7**	Ádám Balog, Andrea Bártfai-Mager, Ferenc Gerhardt, Csaba Kandrács, György Kocziszky, György Matolcsy, László Windisch
In favour of maintaining the base rate at 2.40%	**1**	János Cinkotai

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

Ádám Balog
Andrea Bártfai-Mager
János Cinkotai
Ferenc Gerhardt
Csaba Kandrács
György Kocziszky
György Matolcsy
László Windisch

The Council will hold its next policy meeting on 22 July 2014. The minutes of that meeting will be published at 2 p.m. on 6 August 2014.