MINUTES

OF THE MONETARY COUNCIL MEETING

24 MARCH 2015

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 AND INTEREST RATE DECISION

At its meeting, the Monetary Council discussed the baseline projection in the *Inflation Report* to be published on 26 March 2015 and took a review of the Bank's inflation target. In the Council's view, persistently loose monetary conditions were consistent with the achievement of price stability. Furthermore, the Council judged that inflation was likely to be significantly below the inflation target this year, and was expected to rise to levels around 3 per cent only towards the end of the forecast period. Domestic economic growth might continue to be robust, with domestic demand remaining the main engine. There continued to be a degree of unused capacity in the economy and inflationary pressures were likely to remain moderate for a sustained period.

Differences remained across regions of the global economy in terms of economic growth. Of the world's developed regions, the recovery in the euro-area economy was stronger than expected but modest, while growth in the US was robust. Growth was stable or slowing in most of the major emerging market economies. Global inflation remained moderate, in line with the decline in commodity prices, particularly persistently low crude oil prices and subdued demand, and inflationary pressure in the global economy was likely to remain moderate for a sustained period looking ahead. There had been differences in the monetary policy stance of globally influential central banks in recent months: the ECB had extended its quantitative easing programme while the Fed had maintained its monetary policy instruments. Monetary conditions remained loose overall and, consequently, global interest rate and liquidity conditions continued to be supportive.

The Council expected inflation to be significantly below the inflation target over the short term. At the beginning of the year, inflation had turned out to be below the projection in the December 2014 issue of the *Inflation Report*, due primarily to the decline in commodity prices. Domestic inflation was likely to be substantially below the target in the first half of the forecast period, mainly as a result of strong cost shocks. With the pick-up in domestic demand and reflecting the increase in wages, core inflation was likely to rise gradually; however, this process may slow due to the second-round effects of declining commodity prices. Overall, more moderate underlying inflation developments pointed in the direction of a low inflation environment, and therefore inflation was expected to approach levels around 3 per cent towards the end of the forecast period. The stabilisation of expectations over the recent period was likely to ensure that price and wage-setting will be consistent with the inflation target over the medium term as domestic demand recovered.

Growth in the domestic economy had continued over the past quarter. In the coming quarters, domestic demand was still likely to be the main engine behind growth. Rising household real income as a result of low inflation and increasing employment were expected to contribute to the increase in household consumption. The measures taken in the wake of the uniformity decision by the Supreme Court were likely to contribute significantly to an improvement in the wealth and income position of households, thereby supporting the deleveraging process. In addition, the conversion of foreign currency loans into forints reduced households' exchange rate exposure, which in turn might lead to a gradual reduction in precautionary savings. Investment was likely to grow gradually, due to the pick-up in activity and the extension of the Funding for Growth Scheme. In line with the improvement in income positions, household investment activity was expected to rise steadily over the forecast period. In addition, the rate of export growth was likely to remain robust, reflecting higher growth in Hungary's export markets. The negative output gap was expected to close at the end of the forecast period, and therefore the real economic environment was likely to continue to have a disinflationary impact in the coming quarters. Disinflationary effects from the global economy remained strong, while the price depressing effect of domestic demand was likely to diminish gradually.

As seen in previous periods, the four-quarter value of the economy's external position had continued to be high in the third quarter of 2014. Over the coming quarters, the current account surplus and the external financing capacity of the economy were expected to stabilise at a high level, reflecting two opposing effects. The trade surplus was likely to grow in the coming quarters despite rising consumption and a modest pick-up in investment, mainly reflecting the improvement in the terms of trade and rising external demand. This effect was likely to be reduced by the end of the budget period of European Union funding, which might lead to a significant reduction in the transfer account balance in 2016. The country's external debt ratios, key in terms of the country's vulnerability, were likely to continue to decline, reflecting its high external financing capacity. The Bank's self-financing programme and the expected fall in banks' external debt due to the conversion of foreign currency loans into forint would contribute to the reduction in gross debt.

International investor sentiment had been generally positive in the past quarter. Global risk appetite had been volatile at the beginning of the year, before improving from the end of January. The deterioration in sentiment due to the political events in Greece, the abandonment of the exchange rate cap by the Swiss National Bank and the escalation of the conflict between Ukraine and Russia had been offset by announcements related to the ECB's asset purchase programme and favourable economic news from the US. Of the domestic risk indicators, the CDS spread had fallen sharply over the past quarter. Long-term yields on forint-denominated bonds had remained broadly unchanged since publication of the December *Inflation Report*. The forint had appreciated against the euro in the past quarter, due mainly to international factors. Hungary's persistently high external financing capacity and the resulting decline in external debt had contributed to the reduction in its vulnerability. The upgrade by Standard & Poor's in March also reflected the improvement in perceptions of the risks associated with the Hungarian economy. In the Council's judgement, however, a cautious approach to monetary policy was still warranted due to uncertainty in the global financial environment.

Overall, downside risks to inflation had increased relative to the December *Inflation Report* assessment. The Monetary Council considered three alternative scenarios around the baseline projection in the March *Report*, which might influence significantly the future conduct of monetary policy. The alternative scenario assuming persistent deflation in the euro area posed downside risks to inflation and growth, and therefore looser monetary conditions than assumed in the baseline projection ensured the achievement of the inflation target. Lasting geopolitical tensions could lead to a decline in external demand, associated with a rise in the risk premium. The resulting exchange rate depreciation might raise inflationary pressures, and therefore a tighter monetary policy stance ensured that the inflation target was met at the forecast horizon. In case the alternative scenario assuming more considerable second-round effects of the cost shocks, inflation expectations might move away from the target, resulting in a significantly lower path for nominal wage growth. All this could lead to lower inflationary pressure in the medium term, which called for looser monetary conditions than assumed in the baseline projection during the period.

In the Council's judgement, there continued to be a degree of unused capacity in the economy and inflationary pressures were likely to remain moderate for a sustained period. The real economy was likely to have a disinflationary impact at the policy horizon and the negative output gap was expected to close only gradually. Based on data becoming available earlier, the probability of second-round effects taking hold in the wake of the change in inflation expectations had increased.

The Council judged that, in line with the March *Inflation Report*, the outlook for inflation and the cyclical position of the real economy pointed in the direction of a reduction in the policy rate and loose monetary conditions for an extended period. The Council therefore decided to lower the base rate. All members voted in favour of reducing the base rate. During the discussion, several members noted that the baseline projection in the March *Report* pointed in the direction of a cut in the policy rate. In line with this, the Bank's room for manoeuvre had increased in recent months. Some decision-makers added that, in addition to the favourable financial market environment, financial stability considerations also supported a loosening of policy. In terms of the magnitude of the interest rate reduction, the vast majority of decision-makers preferred a 15 basis point cut, arguing that such a move was consistent with the Bank's earlier cautious behaviour and market expectations, and therefore it contributed to the Bank's credibility and predictability and allowed adequate room for the continuation of the easing cycle looking forward. One member preferred a smaller interest rate cut, which that member explained by the cyclical position of the economy and financial stability considerations arising in the wake of the imminent increase in interest rates by the Fed.

After the discussion, the Chairman invited members to vote on the proposition put to the Council. Members agreed on the need for reducing the base rate. Re-starting the easing cycle, eight members voted in favour of reducing the base rate by 15 basis points and one member voted to reduce it by 10 basis points. Decision-makers agreed that cautious easing of monetary conditions might continue as long as it supported the achievement of the medium-term inflation target.

At its meeting, the Council took a scheduled review of the Bank's inflation target, in addition to discussing the level of the policy rate. As a result of the review, the Monetary

Council decided to improve the flexibility of the inflation targeting regime and designated a ±1 percentage point tolerance band while maintaining the inflation target defined as a 3 per cent rate of increase in the domestic Consumer Price Index published by the Central Statistical Office. Some decision-makers pointed out that while the review of the inflation target had fallen due, the re-start of the easing cycle had created a favourable environment for the announcement. This move was also intended by members to confirm that meeting the 3 per cent inflation target continued to be their goal.

The majority of decision-makers thought it important to note that they interpreted the 3 per cent ±1 percentage point band to be a tolerance band rather than a target range, i.e. they continued to target the 3 per cent middle of the band, instead of a 2–4 per cent range. In this spirit, they did not tolerate an inflation rate significantly and persistently different from the centre of the band and agreed that the band denoted that to the extent that inflation fluctuated in response to unexpected shocks, they could look through it temporarily. The Monetary Council makes its decisions in a forward-looking manner, taking into account that changing the policy rate has its strongest effect on inflation and the real economy on a 6 to 8 quarters time horizon. Members agreed that the primary objective of the MNB continued to be the achievement and maintenance of price stability. The conditions for price stability were assumed to hold if economic agents could reasonably expect inflation to remain low and stable looking ahead over a longer period.

All members voted unanimously in favour of improving the flexibility of the inflation targeting regime and introducing a ±1 percentage point *ex ante* tolerance band around the inflation target.

Votes cast by individual members of the Council:

In favour of reducing the base rate to 1.95%	**8**	Ádám Balog, Andrea Bártfai-Mager, Ferenc Gerhardt, Csaba Kandrács, György Kocziszky, György Matolcsy, Gyula Pleschinger, László Windisch
In favour of reducing the base rate to 2.00%	**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

Gyula Pleschinger

László Windisch

The Council will hold its next policy meeting on 21 April 2015. The minutes of that meeting will be published at 2 p.m. on 6 May 2015.