MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 22 FEBRUARY 2010

Article 3 (1) of the MNB Act (Act LVIII of 2001 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 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/engine.aspx?page=mnben_mt_jegyzokonyv

1 Macroeconomic and financial market developments

The domestic economy

In January 2010, annual CPI inflation rose to 6.4% and core inflation to 5.1%. The pick-up in inflation during the month largely reflected increases in prices of excise goods and tradables, as well as base effects from the significant decline in fuel prices last year. These upward pressures were partially offset by the steady fall in services price inflation.

The increase in tradables price inflation in January was evident in a broad range of products, but this is seen as a one-off event. Retailers are likely to have brought forward the bulk of mark-downs from January to December. If this assumed shift in seasonal patterns accounts for the worse-than-expected outturn for tradables price inflation in January, then it will not significantly alter the Bank's view of underlying inflation developments.

The services price index, which has a significant bearing on the inflation outlook, remains at a historically low level. As the overwhelming majority of price adjustments take place in January, this low outturn means it is likely that prices will grow at a subdued pace over the whole year.

Last year's decline in food price inflation did not continue in the early part of 2010. By contrast, fuel prices rose sharply due to the increase in excise tax and the base effect from last year.

Hungarian GDP fell by 4% in 2009 Q4, as the economy contracted further. The recession, however, has turned out to be less severe than the Bank previously expected. This positive surprise may have been caused by industrial output, which was buoyed by strengthening external demand. The value added of companies producing for the domestic market may have continued to decline sharply.

Slack domestic demand was also confirmed by the November retail trade data. The total volume of retail sales fell by 12.5% relative to a year earlier. The contraction in demand was spread across virtually all product groups, although consumer durables continued to be affected most severely. Falling real wages, rising unemployment and increased risk aversion by the banking sector account for households' weak consumption activity. Risk aversion may not only impede new borrowing – it also reduces disposable income of those households with debt, as margins on lending remain at high levels. Although the outstanding stock of lending by the seven largest domestic banks rose again in January for the first time since the summer of 2008, household net borrowing is only expected to turn positive towards the end of the year.

Rising external demand had a benign impact on the performance of the Hungarian export sector in Q4, but the recovery in domestic export activity stalled in December as the effects of stockbuilding and the fiscal stimulus packages implemented by euro area governments wore off. Industrial production fell by 5.7% in the span of one month. Similar developments took place in other countries of the CEE region. The value of both exports and imports fell in the final month of 2009, with the trade balance settling at the levels of the previous months.

Private sector gross average earnings rose by 4.3% year on year in December. Subdued growth in earnings was consistent with the picture of weak domestic demand and loose labour market conditions. In terms of the various sectors, there was a marked decline in service sector bonus payments, mainly accounted for by financial service providers.

According to the CSO Labour Force Survey, the seasonally adjusted number of people in employment stopped falling in Q4. Employment is likely to have stagnated in the government and private sectors. Due to increasing activity, the number of unemployed rose.

According to the projections in the February issue of the *Quarterly Report on Inflation*, the economic downturn will be protracted and the disinflation process will be slow. As the base effect of increases in indirect taxes fades, core inflation may decline towards the 3% target and then below that level in 2011. The slower-than-anticipated decline is accounted for by rises in oil and administered prices. Core inflation is likely to fall below the target in 2010 H2. Much lower services price inflation than in previous years is expected to aid the disinflation process. Real economic activity continues to be driven by the divergent trends in external and domestic demand. Growth is only expected to resume in 2010 H2, and to pick up tangibly in 2011. Employment is likely to continue falling this year, with wage growth remaining very subdued. The balance of payments is forecast to move to near balance this year as the effects of cyclical factors wane.

Financial market developments and the vulnerability of the banking sector

Financial markets

Economic data released over the past few months generated uncertainty for market participants in respect of the risks facing euro-area Member States in a relatively weaker fiscal position, the sustainability of economic activity in the US and the tightening of monetary policy by the Chinese authorities. Overall, market developments were shaped by uncertainty surrounding the financing of Greek government debt, which was instrumental in bringing the issue of euro area stability to the fore. As a result, risk appetite in the global money and capital markets was lower than in previous months following the Council's interest rate decision in January.

Recent developments in exchanges rates, stock market indices and credit risk premia are an indication that markets react more to negative news than to positive news. The euro weakened against the major currencies and there was a significant increase in the CDS spreads of both low-risk and peripheral countries, as divergences across countries raised questions over the viability of the euro area as a whole. Government securities yields in low-risk Member States rose only modestly from their January levels, but the sharp rises in peripheral countries continued. Yields rose slightly in other developed markets, while short-term rates in money markets continued to fall.

Risks associated with the Hungarian economy and other emerging economies were perceived similarly, with country-specific factors playing little role. The five-year sovereign CDS spread rose from around 220 basis points in the first half of January to above 250 basis points; and the spread of the five-year government bond over German Bunds of comparable maturity rose by 20 basis points. Of the currencies of the CEE region, the zloty and the koruna appreciated against the euro, while the leu and the forint remained virtually unchanged at the levels of a month earlier. The forint exchange rate fluctuated within a range of EUR/HUF 269–275, mainly reflecting international trends. Neither implied volatilities nor the Reuters poll suggested a shift in exchange rate expectations: analysts expected the exchange rate to remain flat in the short term and to appreciate slightly on a one-year horizon.

The build-up of long forint positions by non-residents has continued at a modest pace in recent weeks. Their outstanding FX swaps have increased by more than HUF 70 billion in the period since the last interest rate decision. The increase in the sector's government securities holdings slowed somewhat after the sharp rise in January, and its holdings of quoted shares fell by some HUF 45 billion. Non-residents bought more than HUF 30 billion in the spot foreign exchange market to finance their forint asset purchases, and they are believed to have acquired the remaining part by reducing their existing forint deposits.

There was no significant reduction in the record steepness of the yield curve. Short-term yields fell by 5–15 basis points and yields at maturities between 5–10 years fell modestly. Auction results were mixed: although yields were falling, some auctions were only slightly oversubscribed. As a positive development, demand by foreigners for government securities on offer at auctions picked up. Liquidity conditions in the secondary market were broadly unchanged.

Based on FRA quotes, the market's interest rate expectations have hardly changed: a 25 basis point reduction is priced into quotes for the Monetary Council's meeting on Monday, but participants attach an equal probability to interest rates being maintained or reduced by 25 basis points. The bottom of the interbank interest rate curve expected by the market has remained between 5.5%–5.75%. According to the survey conducted by Reuters, short-term interest rate expectations reflect a relative consensus: 21 economists expect a 25 basis point reduction and four expect interest rates to remain on hold. Expectations for the low point of the easing cycle have not changed: the median is still 5.5%. The majority of forecasters expect the current easing cycle to end in 2010 Q1, and the ratio of those who do not expect that interest rates will be reduced further following the Council's Monday meeting has increased.

The stability of the banking sector

In the final quarter of 2009, lending activity of the domestic banking sector was weaker than expected. The decline in lending to both companies and households accelerated. Banks' outstanding lending to the corporate sector rose for the first time in 16 months, but only slightly. This, however, did not represent a clear reversal of the steady downward trend: lending may continue to fall in the coming months, according to the MNB's latest lending survey.

The reduction in corporate lending is likely to have continued, as banks tightened further their credit standards over the past quarter. Tightening was reflected mainly in non-price terms (e.g. higher collateral requirements and stricter credit scoring criteria), which made it more difficult for less creditworthy borrowers to access credit, while fierce competition for the most creditworthy customers continued. Looking ahead, it is not likely that credit standards will be eased: lenders plan to maintain stringent lending criteria over the next six months, and still intend to increase the supply of credit for a highly selected range of potential borrowers. As to the reasons for restrained credit supply, although domestic banks have maintained their strong ability to lend, i.e. their liquidity and capital positions are adequate, their risk appetite continues to be low, making it more difficult for customers to access credit, as confirmed by both survey responses and available banking sector data.

In January 2010, the decline in outstanding household credit continued. Foreign currency loans accounted for the entire fall, whereas the stock of forint loans rose. Banks mainly eased their price terms on forint mortgage loans, which played a significant role in the changing composition of new forint lending. In consequence, the interest differential between forint and euro-denominated mortgage loans fell below 2 percentage points in December 2009. Based on survey responses, banks' willingness to grant mortgage loans may increase in the future, but tight non-price terms (selective lending policies) may remain, associated with falling interest rates. The entry into effect on 1 March 2010 of the provisions on loan-to-value ratios of the government decree on prudential lending may amplify this trend.

According to available preliminary data, both companies and households withdrew substantial amounts from their deposits in January 2010. Withdrawals were only partially offset by an increase in deposits of money market funds. This slowed banks' balance sheet adjustment and, moreover, the loan-to-deposit ratio began rising again in January, which may be an indication that the increase in the household saving ratio has come to a halt.

The domestic banking sector has become more stable in recent months. The ratio of non-performing loans rose to 10% and 7% for companies and households, respectively, by the end of the year (the projection in the November 2009 *Report on Financial Stability* was that the NPL ratio would increase to 11.3% and 10.3%). Meanwhile, provisions reduced bank earnings by 2.4% in the corporate segment and by 2.5% in the household segment (versus 3% in the November *Report* forecast). This deviation from expectations was largely explained by the fact that the percentage share of restructured loans increased significantly, which, in turn, reduced banks' liability to set aside provisions for impaired loans; and lenders managed to slow the rise in the ratio of non-performing loans. Preliminary data for the end of the year, however, suggest that the sector's profitability was broadly comparable with the results for 2008, despite much higher provisions for loan losses: including results for branches, the sector's ROA was 1.0% and its ROE 12.5%, according to end-of-year preliminary data (compared with 1.1% and 14.1%, respectively, at the end of 2008). That was accounted for in large part by one-off income from financial transactions and in small part by rising interest income. The capital adequacy ratio rose to nearly 13%, from 11% at the start of the year. Hungarian banks' profitability is very high by international standards. Within the region, profitability is only higher in Bulgaria and the Czech Republic, according to available data.

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

After considering the outlook for the economy and inflation presented in the February *Quarterly Report on Inflation* as well as recent developments in the world's financial markets, the Monetary Council made a cautious reduction in the central bank base rate. Members were of the view that a further reduction in interest rates, even though justified by macroeconomic conditions, could only take place if perceptions of risks associated with the economy improved on a sustained basis.

In the Council's judgement, the latest macroeconomic data suggested that the outlook for activity had not improved on the whole, which prompted a continued, sharp adjustment by the domestic sectors. Some members cautioned that signs pointing to faster economic growth were not yet in sight, and reducing risks to growth continued to pose a significant challenge for economic policy. Several members noted that it was difficult to judge the external outlook: on the one hand, global growth might slow as the earlier economic stimulus packages ran their course, while, on the other hand, confidence measures pointed to a stronger picture.

Council members agreed that the MNB's inflation target could be met from mid-2010, after the effects of the indirect tax increase unwound. Several members, however, viewed the upward revision to the inflation projection for 2010–2011 relative to November – in reflection of the impact of external shocks – as a negative development. If the rise in oil prices and administered prices as well as the trend triggered by the appreciation of the US dollar continued, then the risk of once again overshooting the inflation target might increase. Some members thought that all this had to be given significant weight in setting monetary policy, as the risks of overshooting the target might be greater in terms of the central bank's credibility than the risks of undershooting it. On another argument, however, the costs of undershooting the inflation target should not be neglected either and, therefore, the higher inflation projection for 2011 was favourable from the perspective of monetary policy.

In evaluating the trends in domestic lending, several members stressed that past data suggested that balance sheet adjustment by households and declining demand for credit may have played an important role in the drop in lending, while the tightening in the supply of credit may have made it more difficult for small and medium-sized companies to borrow. It was also argued that, for this reason, banking sector profitability might deteriorate in the future, prompting banks to set aside higher provisions for loan losses and to restore profitability.

Monetary Council members attached particular importance to the news on the Greek financial crisis, which had a negative impact on sentiment towards the euro area as a whole. Several members thought that the lengthy process of consultations before international assistance was provided might add to uncertainty in financial markets. Although market asset prices suggested that the events in Greece had not yet had a significant influence on domestic developments, Hungary might eventually be affected through several channels because of its vulnerability.

The majority of Council members agreed that there was scope to continue the series of cautious interest rates cuts which had started at the end of last year. From an inflation and a real economic perspective, interest rates could be reduced further, but the room for manoeuvre had been reduced by the fact that there had been little change in risk perception in the past 3–4 months, even though there had been some deterioration in international investor sentiment, which had had only a minor impact on the risk perception of Hungary. Some members were of the view that the current level of the base rate could be considered low compared with other countries belonging to the same risk category, which might justify leaving interest rates unchanged. Those supporting a larger interest rate reduction argued that the inflation projection for next year was significantly below the target. In addition, the US Federal Reserve's recent policy action might imply a change in direction for the global interest rate cycle, which might narrow the room for manoeuvre for monetary policy in Hungary. The majority of members judged that the series of gradual reductions in interest rates since July 2009 might come to an end at any of the Council's next few meetings, due to current perceptions of risks associated with Hungary and continuing uncertainty in international financial markets. At the same time, the current level of inflation and the real economic environment still warranted a reduction in interest rates, and consequently, the base rate might be reduced further if future domestic and external developments were favourable.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Six members voted to reduce the base rate by 25 basis points, two members preferred a 50 basis point reduction and one member voted to maintain the base rate unchanged.

Votes cast by individual members of the Council

In favour of reducing the base rate to 5.75%	**6**	Péter Bihari, Vilmos Bihari, Csaba Csáki, Ilona Hardy, Ferenc Karvalits, András Simor
In favour of reducing the base rate to 5.50%	**2**	Tamás Bánfi, Judit Neményi
In favour of maintaining the base rate at 6.00%	**1**	Júlia Király

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

Tamás Bánfi
Péter Bihari
Vilmos Bihari
Csaba Csáki
Ilona Hardy

Ferenc Karvalits
Júlia Király
Judit Neményi
András Simor

Álmos Kovács, State Secretary of the Ministry of Finance, was present as the Government's representative.

The Council will hold its next policy meeting on 29 March 2010. The minutes of that meeting will be published at 2 p.m. on 14 April 2010.