MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 23 FEBRUARY 2009

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 2009, annual CPI inflation increased by 3.1% and core inflation by 3.4%. Both measures of inflation fell by 0.4 percentage points compared with December. Items excluded from the core inflation measure played a less important role in the decline than in the previous month, while the easing in services price inflation accounted for a greater share. The much slower increase in services prices than usual suggests a break in the inflation inertia characteristic of previous years. The increases in the prices of processed foods and durable goods were somewhat surprising, which, however, could be related to individual items in both product categories. In the February issue of the *Quarterly Report on Inflation*, inflation is projected to rise above the target in 2009 H1, assuming that the announced increases in VAT and other indirect taxes are implemented; however, inflation net of the effects of the planned tax measures may remain below target over the entire forecast period. This projection is based on the worsening global economic environment and declining domestic activity.

According to the preliminary release by the CSO, Hungary's gross domestic product fell by 2.0% (by 2.1% adjusted for calendar effects) in 2008 Q4 compared with the same period of the previous year, implying annual growth rates of 0.6% and 0.3%, respectively, in 2008 as a whole. Following a slight pick-up in the economy in the first half of the year, gross domestic product fell sharply in the second half, due to a marked deterioration in general macroeconomic conditions. And although other countries of the CEE region performed similarly in the period, conditions in Hungary were already much worse even before the onset of the current global crisis, leading in turn to a sharper downturn compared with its competitors. In view of the fact that the CSO's latest release does not include a detailed breakdown by activity, the decline is currently believed to have been caused by falling household consumption and investment demand. On the output side, it is important to note that the outstanding performance of the agriculture sector in 2008 partly offset the decline. According to available information, there was a clear downturn at the sectoral level. As a combined effect of deteriorating external business activity, falling credit supply and the likely implementation of fiscal measures, the domestic economy is expected to suffer a greater downturn over the next two years than previously expected.

In November–December 2008, industrial production and trade in goods both dropped off significantly – even more sharply than in previous months of the year. Although the decline was general, the key industries producing for export markets experienced the largest decline as a consequence of the weakening international environment. This was clearly reflected in sales data as well. In the period under review, the fall in imports of goods was broadly similar to that in exports, with the result that the trade balance improved slightly.

Whole-economy gross average earnings rose by 4.6% in December 2008 compared with a year earlier. Within this figure, earnings fell by 2.1% in the government sector and rose by 7.4% in the private sector over twelve months. Accordingly, private sector earnings growth was 7.1% in 2008 Q4 and 8.5% in 2008 as a whole.

Financial markets

Over the last month, global investor sentiment has been fragile and volatile. Although risk measures fell slightly, stock market indices rose only temporarily, and implied securities market volatilities remained at high levels.

Central banks around the world eased monetary policy further, in response to the expected prolonged recession and continued disinflation. A number of developed countries, including the UK, Australia, Canada, New Zealand, Norway and Sweden, reduced interest rates again, as a result of which official rates reached record lows in some instances. As rates fell close to zero, an increasing number of central banks (such as the Bank of Japan, the Bank of England and the US Fed) have resorted to alternative instruments outside the realm of conventional monetary policy to mitigate the pace of decline. The ECB left interest rates unchanged at 2% at its February meeting, consistent with market expectations, but expectations of further rate cuts intensified in part due to the dovish tone of the Bank's statement accompanying the decision. A 50 basis point cut at the Governing Council's next meeting is therefore priced into the market. Further ahead, asset prices imply a reduction in official rates to 1% by the middle of the year. Central banks in Central and Eastern Europe all reduced interest rates: the National Bank of Poland cut rates by 75 basis points, exceeding market expectations; the Czech National Bank reduced rates by 50 basis points to 1.75%; and the National Bank of Romania began to ease policy with a 25 basis point cut.

Exchange rate movements in the region over the last month were driven fundamentally by a growing difference in investors' attitude towards Central and Eastern Europe and other emerging market regions of the world, with a significant deterioration in sentiment towards the former in relative terms. Within the CEE, the zloty depreciated by more than 11%, suffering the largest decline, the Czech koruna fell by 6%, and only the Romanian leu remained broadly stable. The Hungarian forint weakened significantly, by nearly 9% against the euro, accompanied by high volatility. There was a marked change in long-term expectations as well, with a clear shift in expectations regarding the likely course of the mean exchange rate towards more weakness. Respondents to the regional survey conducted by Reuters in early February expect the exchange rate to fluctuate between EUR/HUF 290–300 over a longer period, before recovering slightly towards EUR/HUF 285 on a one-year horizon.

Over the past month, conditions in the Hungarian government securities market have deteriorated. As the exchange rate fell, the secondary market experienced renewed selling pressure, followed by the recurrence of liquidity problems and a sharp rise in yields. Yields at the short end of the curved rose by 130–210 basis points and by 230–310 basis points at the long end. Although with some delay, the deterioration in secondary market conditions was also felt in the primary market, which was reflected in rises in yields and weak demand at some auctions. Meanwhile, the spread over interest rate swaps of government securities rose sharply at every maturity, widening to 140–240 basis points. There were less dramatic changes in non-residents' holdings of government paper compared with the government securities market: while holdings were broadly static at the beginning of the period, non-residents were selling their forint-denominated government paper in the last few days, albeit not on a massive scale.

Expectations of the future path of official interest rates changed significantly in the wake of the developments during the month. Asset prices and surveys of analysts both reflect significant erosion of expectations regarding future interest rate cuts. A 25 basis point increase in official interest rates is priced into forward rate agreement (FRA) rates for the coming months, whereas the base rate may fall slightly below the current level by the end of the year, based on the FRA rates. The consensus forecast in the Reuters poll of economists is for official interest rates to remain on hold at the Monetary Council's next meeting.

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

Members of the Council agreed that the global economic environment and the prospects for growth both had deteriorated more sharply than expected, and the current recession may consequently be deeper and more protracted. Inflation might fall below the Bank's 3% target over the medium term, after the upward effects from the tax increases faded. The risks related to the outlook for inflation appeared to be balanced. At the same time though, the global financial turmoil had affected Central and Eastern Europe particularly adversely. All of this required a cautious, wait-and-see policy stance.

There was no inflationary pressure in the domestic economy, due to the deterioration in the outlook for economic activity. In the current downturn, a rise in inflation caused by one-off measures was highly unlikely to have a lasting impact on inflation expectations and would not jeopardise the Bank's inflation target.

Several members noted that, following the easing in liquidity strains in the financial markets, the focus had shifted to problems in the real economy and lending, in which structural funding problems played a prominent role. The sharp decline in external demand had led to a greater-than-expected downturn in economic performance in the entire CEE region. The deterioration in prospects was reflected in rises in bond market yields and risk measures as well as in the poor performance of stock market indices. Several members pointed out that one of the main reasons for the deterioration in sentiment was that the global recession might have a more pronounced effect on the countries in the region, due to their high degree of integration with western Europe, their geographical location, export orientation and dependence on external financing. In addition, some countries faced problems with financing their high debts as well as risks of portfolio deterioration and capital loss in the financial intermediary system.

In the Council's judgement, Hungary, unlike other countries, had no room to tackle the problems in the economy by implementing stimulus packages. In the current circumstances, the task of monetary policy was to facilitate adjustment to the new global economic environment. However, this adjustment required further government action. Several members noted the experience with the economic adjustment of 2006, and warned that while the 2006 adjustment was clearly feasible and market reception would have been positive in time, the same could not be said about the measures announced by the Government so far. At the same time, however, several members noted that implementation of the fiscal measures announced so far would help to place the economy on a sustainable growth path over the long term.

Some members thought that central European currencies had depreciated to an extent and at a pace which could lead to financial market disruption and should be avoided. International analyses cited the high current account deficits, the sharp decline in European demand with its concomitant adverse impact on export-oriented economies and the related deterioration in prospects, and the strong dependence of local banks on foreign funding as reasons behind the depreciation of the currencies in the region. Although some exchange rate adjustment was appropriate due to continued deleveraging around the world and the deterioration in financing conditions, the degree to which the current protracted shock had affected the region and Hungary was greater than justified by economic fundamentals and changes in conditions.

In the Council's judgement, under the current circumstances monetary policy had to adopt a wait-and-see approach. Several members stressed that monetary policy actions could only play a marginal role in resolving the problems facing the region.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. The Council voted unanimously to leave the base rate unchanged.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 9.50%	**9**	Tamás Bánfi, Péter Bihari, Vilmos Bihari, Csaba Csáki, Ilona Hardy, Ferenc Karvalits, Júlia Király, Judit Neményi, András Simor

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

Dr Katalin Haraszti, Head of Department of the Ministry of Finance, was present as the Government's representative.

The Council will hold its next policy meeting on 23 March 2009. The minutes of that meeting will be published at 2 p.m. on 10 April 2009.