MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 25 MAY 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 April 2009, the steady decline in inflation seen during the previous months was interrupted. While the annual rate of core inflation remained unchanged at 3.1%, the consumer price index rose by 0.5 percentage points to 3.4%. This increase in the CPI was driven mainly by rises in the prices of individual items in the tradable goods category. As the volatility of tradables prices has increased substantially in recent months after periods of stable development, it is difficult to judge the extent to which this reflects higher exchange rate pass-through or statistical noise. The tradables index, calculated by filtering out abruptly repriced goods, is on a mildly upward trend. This is consistent with what has been expected on the basis of exchange rate pass-through. By contrast, the core inflation index is trending marginally lower.

The monthly outturn for services price inflation was largely in line with the seasonal patterns observed in previous periods, with the annual index changing only slightly compared with the beginning of the year. Although the decline seen in January did not continue, there was also no correction. In the core inflation measure, food prices were the only category to show signs of a moderation in inflation. In the projection in the May issue of the *Quarterly Report on Inflation*, the consumer price index rises above 6% this year as an effect of the increases in VAT and indirect taxes, while net inflation, which excludes the effects of the Government's measures, remains below target over the entire forecast horizon. Over the short term, the low inflation environment can be attributed to an easing in imported inflationary pressure, and, in the medium term, to falling domestic consumption.

According to preliminary 2009 Q1 data, Hungary's gross domestic product declined by 6.4% (by 5.8% after adjusting for the calendar effect) compared with the same period of the previous year, meaning that the economic recession deepened further. While initially the drop in output was caused mainly by the first-round effects of the rapid deterioration in international economic activity, the negative influences from domestic demand became increasingly pronounced in the past quarter. In a regional comparison, the economies of Central and Eastern Europe were also adversely affected by the global recession. The region's total output fell substantially in 2009 Q1. As a result, the gross domestic product of Hungary's major competitors declined nearly comparably with Hungarian GDP, despite the differences in their initial positions.

Based on 2009 Q1 data for industrial production and trade in goods, the sharp decline in late 2008 did not continue in 2009. Developments in domestic business activity are broadly consistent with those observed in the euro area and Central and Eastern Europe. In March, the trade balance registered the highest surplus in the last few years and the country's terms of trade improved significantly. The slight increase in industrial output was reflected across a broad range of industries.

Looking ahead, global output data, continuing weak new domestic and international orders and slightly rising confidence indicators suggest that a sharp turnaround is unlikely, although domestic industrial activity may improve gradually from month to month. The *Report* projection assumes that the Hungarian economy will suffer a deeper decline than the European average, as the slowdown in business activity abroad, the tightening in the supply of credit and the Government's fiscal measures simultaneously exert negative effects on growth. Consequently, GDP may fall by nearly 7% this year and by around 1% next year. However, the economy is expected to begin to pick up strongly from 2011.

The rates of growth for both regular and gross earnings in the private sector continued to moderate in 2009 Q1. Generally, the annual indices reflect only carry-over effects, as regular pay and gross earnings both remained unchanged compared with the previous quarter. It is important to note, however, that, particularly in the case of market services, the monthly outturns are higher than the February data. This is explained in part by the timing effect and in part by the increasingly more marked composition effect stemming from lay-offs of low-productivity labour. Overall, in Q1 firms responded to deteriorating profitability mostly by shedding labour, while they held nominal wages virtually unchanged. The degree of adjustment appears greater in manufacturing, where the number of employees, as well as wages and hours worked all fell.

Financial markets

Over the last month, the optimistic mood of global investors characterising the financial markets since the end of March remained intact, but signs of a weakening in sentiment have appeared more recently. In the first part of the period, the world's leading equity indices extended the upward trend which began at the end of the March. But markets then retraced some of the upward movement in May, which, however, cannot be regarded as a clear trend reversal. Investors' willingness to take risks increased considerably, as reflected in a decline in spreads on risky assets and an easing in risk indices and implied equity market volatilities. Liquidity in global money markets, and particularly in US dollar markets, has been improving. But while liquidity problems are easing, the solvency problems of the financial system are becoming more pronounced and this is a cause for concern.

Of the world's leading central banks, the European Central Bank lowered its key policy rate by 25 basis points. Interest rate cuts in a number of other developed countries (e.g. in Denmark, Sweden and Norway) also continued. The central banks with limited room for adjusting interest rates contributed to an easing in monetary conditions by pursuing quantitative easing policies. Taking advantage of improved investor sentiment, central banks in a number of emerging countries also reduced their interest rates. In Latin America and Asia, official interest rates were reduced by 50–100 basis points. Of the other emerging economies, interest rates remained unchanged in Poland, but they dropped by 25 basis points in the Czech Republic, by 50 basis points in Turkey and Romania and by 100 basis points in South Africa and Serbia. The expected paths for growth would argue in favour of further interest rate cuts, but the previously experienced substantial exchange rate weakening in several countries limits the scope for policy easing.

Ongoing improvement in investor sentiment had a positive impact on emerging markets, as evidenced by exchange rate strengthening and declines in risk spreads. Both foreign currency bond spreads and CDS prices fell markedly. This improvement continued even when the correction in the developed markets was already under way. Encouragingly, investors now take into account returns in their portfolio allocation decisions, and they no longer focus on the safest assets, as reflected in the substantial depreciation of the dollar. In the case of risky assets, the increase in risk appetite was reflected not only in the decline in risk spreads, but also in the strong interest in foreign currency bond issues. In the Czech Republic and Poland, euro bonds were issued in the amounts of EUR 1.5 billion and EUR 0.75 billion, respectively.

The forint appreciated by some 6% in the past month, significantly outperforming the other currencies in the region. In the first decade of the month, the exchange rate moved broadly together with the Czech koruna and the Romanian leu, whereas in subsequent weeks it more closely followed movements in the Polish zloty. Nevertheless, the forint exchange rate still exhibits wider swings both during periods of appreciation and depreciation, and, moreover, the appreciation occurred at a time when market liquidity was low. Parliamentary approval of the Government's plans to improve the soundness of public finances also contributed to the improvement in sentiment towards Hungary, in addition to global factors. Nonetheless, political risks are still thought to be higher in Hungary than elsewhere in the region. There remains uncertainty over exchange rate expectations: implied volatilities derived from option prices fell at every maturity, suggesting that the recent strength of the exchange rate could be sustained. However, no change has occurred in the negative skewness in the distribution of exchange rate expectations. The survey conducted by Reuters in early May paints a favourable picture: exchange rate expectations of respondents are some HUF 10 lower compared with the level in April. Analysts expect the exchange rate to be EUR/HUF 291 over a three-month horizon and 277 at the end of the year. That translates into modest appreciation relative to the exchange rate prevailing at the time of the survey. The exchange rate strengthening seen in recent weeks, however, exceeds this expectation, which may suggest the potential for the exchange rate to overshoot.

In the FX swap market, liquidity conditions were normal, with implied forint yields both against the dollar and the euro moving close to the interest rate corridor. Over the past month, non-residents' net outstanding FX swap commitments fell by HUF 550 billion, while in the spot market they made net forint purchases in the amount of nearly HUF 300 billion. This may indicate that investors are attempting to take advantage of the yield differential in the FX swap market. Domestic non-banks' outstanding forward contracts remained broadly unchanged, despite the significant exchange rate appreciation.

Amidst still very illiquid conditions, there have been some signs of improvement recently in the domestic government securities market. Yields have fallen sharply, reflecting the generally positive international investor sentiment: in addition to the decline at short maturities, yields on securities at maturities of one year and over are now some 80 basis points lower than a month ago. It is difficult to assess the demand of foreign investors whose purchases tend to be large, due to the relatively small issues of government paper, which causes some uncertainty with regard to judging the health of the government securities market. At the recommenced government bond auctions, the Debt Management Agency has sold slightly more than HUF 43 billion of three, five and ten-year bonds. This indicates that bond issuance continues to be too small to offset the decline in outstanding stocks caused by repurchase auctions and maturing paper. It is also noteworthy that at the latest auction of ten-year bonds the amount on offer was not sold in full, and yields resumed rising. At the auctions of discount treasury bills, issues were several times oversubscribed, accompanied by declining yields. Although non-residents' holdings of government paper fell by HUF 100 billion in the past month, their share of total holdings remained relatively stable.

Interest rate expectations, implied by FRA quotes, fell significantly, in line with the exchange rate strengthening: market participants do not rule out a 25 basis point reduction in the coming months, and they expect the path of official interest rates to be clearly downwards over the latter part of the year, with a fall in the policy rate to 8% by the end of the year. Of the 21 analysts polled by Reuters in May, 19 expect interest rates to remain on hold at the Monetary Council's upcoming meeting, one analyst expects a 25 basis point cut and another a 50 basis point cut.

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

Monetary Council members agreed with the finding in the February issue of the *Quarterly Report on Inflation* that there had continued to be no significant inflationary pressure in the economy, despite the unfavourable real economic environment. If Parliament approved the Government's proposed fiscal measures and the improvement in financial market conditions was sustained, the room for manoeuvre in monetary policy could increase.

Although members judged that the macroeconomic outlook had deteriorated compared with February due to the realisation of downside risks to growth, the economy was likely to recover strongly from 2011. Some members noted that the indicators measuring the performance of foreign trade and industry had stopped declining and the terms of trade had improved, resulting in an improvement in Hungary's external balance. Several members pointed out that the domestic sectors had begun to adjust, households' net financial position had improved and the corporate sector had responded to the unfavourable environment by cutting back on investment, employment and the number of hours worked. In addition, the actions taken by the Government could make a significant contribution to an increase in the potential growth rate of the economy and to securing a sustainable debt path for the country.

Members agreed that there were a number of signs that financial market sentiment may have turned around, with a positive shift in sentiment towards emerging countries, and Central and Eastern Europe in particular. The majority of members, however, thought that the Council should maintain a cautious and robust policy stance until those positive developments turned out to be durable. Some members noted that weak demand in the government securities market and low liquidity in the foreign exchange market underscored the need for caution. Some other members pointed out that the general conditions in domestic financial markets continued to be much weaker than in the period before the autumn of 2008. It was also argued in relation to the government securities market that the lack of investor interest could be explained by the deficiencies in market infrastructure rather than fundamental factors. For this reason, further development of the primary market scheme and the secondary market of government securities was needed.

Other members, however, thought that the improvement in market conditions could be regarded as durable, significant and broad-based. On another argument, the sharp economic downturn posed the greatest risk to financial stability, and smoothing the decline could only be possible at a lower level of interest rates than currently. Other members argued that, having regard to the high level of foreign currency debt, the influence of interest rate policy on economic growth had weakened, and, therefore, conventional monetary policy instruments might not be efficient in controlling the decline.

Monetary Council members agreed that the fiscal measures announced recently by the Government could be regarded as very favourable from the perspective of the potential growth of the economy and the sustainability of the country's debt path. The proposed fiscal measures, if implemented, could help improve investor sentiment towards Hungary in the period ahead, whilst several members noted that the measures could provide more room for manoeuvre in monetary policy only after approval by Parliament and positive feedback from the markets.

Several members pointed out that the period since the autumn of 2008 suggested a number of lessons for monetary policy in various respects. Those lessons should be taken into consideration in future decisions. Amongst others, members thought it was important to reconsider the role of the financial intermediary system in the monetary transmission mechanism and to preserve the forward-looking nature of monetary policy. The majority of members suggested that the Council should adopt a wait-and-see approach until Parliament approved the Government's proposed measures and the improvement in sentiment in financial markets proved pervasive and longer-lasting.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Seven members voted to leave the base rate unchanged and two members voted for a 50 basis point reduction.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 9.50%	**7**	Tamás Bánfi, Csaba Csáki, Ilona Hardy, Ferenc Karvalits, Júlia Király, Judit Neményi, András Simor
In favour of reducing the base rate to 9.00%	**2**	Péter Bihari, Vilmos Bihari

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 22 June 2009. The minutes of that meeting will be published at 2 p.m. on 17 July 2009.