MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 22 JUNE 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 May 2009, annual CPI inflation increased by 3.8% and core inflation by 3.1%. The consumer price index rose by 0.4 percentage points, while core inflation remained unchanged compared with the previous month. The pace of increases in unprocessed food prices exceeded the typical seasonal increase around this time of year by a large margin, and this was the main driver of the rise in the CPI. In contrast with previous months, the prices of individual items in core inflation were basically flat, with no outlying price changes observed. The effects of forint depreciation over the past six months have been feeding through gradually into tradables price inflation. The outturn for services price inflation was broadly consistent with the seasonal characteristics of the series for the month. Nonetheless, the widening in the output gap has not been reflected in services prices of recent months, posing some upside risk to the outlook for inflation. The inflation data for May represent an upside risk to headline inflation relative to the baseline projection. Core inflation may remain close to the target throughout the forecast period.

According to the release by the CSO, Hungary's GDP contracted by 6.7% in 2009 Q1 (6.1% after adjusting for calendar effects) relative to the same period of 2008. The trend indicators suggest that the economy has been slipping deeper into recession from the middle of last year. The global economic downturn has also had a pronounced impact on the other economies in the CEE region. A detailed look at data for the first quarter by sector and industry reveals that, in addition to the ongoing deterioration in external demand conditions, the secondary effects of the decline in lending activity and intensifying labour market adjustment have become increasingly evident since the beginning of the year. On the expenditure side, this process has been clearly reflected in the continued weakening in household consumption. Both exports and imports have slowed sharply. The major drivers of the slowdown in exports and imports, respectively, have been the deterioration in global economic conditions and weak domestic demand, in addition to the decline in exports. However, stronger-than-expected net trade (and the considerable reduction in stock levels) may be distorted by one-off effects (for example, the gas crisis and fiscal measures in neighbouring countries). On the output side, the decline in industrial output has been more marked and the performance of the services sector better than expected.

A period of near-stagnation is expected based on the industrial production data for April, following the decline at the end of last year. Although business confidence indices appear to have bottomed out in the past few months, neither international industrial production nor stocks of orders abroad and at home point to a near-term turnaround in economic activity. Developments in domestic economic conditions are still consistent with those in Hungary's major export markets and other countries of Central and Eastern Europe.

Preliminary foreign trade data for April suggest a further improvement in the trade balance for the second consecutive month. The fall in exports in April may have reflected a fading transient effect (i.e. exports of automobile stocks), the decline in industrial production and technical factors. Imports may have fallen due to declining domestic demand, in addition to weaker import demand by industry. Hungary's external balance may continue to improve, reflecting the prolonged decline in domestic demand.

Financial market developments and the vulnerability of the banking sector

Of the international factors shaping investor sentiment towards Hungary, uncertainty about the exchange rate regime in Latvia has posed the greatest risk in the past month. The possibility of another devaluation of the Latvian currency once again brought concerns about the vulnerabilities of the region to centre stage. However, CDS and foreign currency bond spreads suggest that the countries in the region have been affected differently by these problems: spreads rose mostly in the Baltic states, and CDS spreads in Romania and Bulgaria rose by 25 basis points more than in Hungary. Nevertheless, the majority of analysts still consider Hungary to be among the countries exposed to risks.

Reflecting the deteriorating global conditions, non-resident market participants became more cautious about the outlook for Hungarian assets. As a consequence, the build-up of long forint positions did not continue in the FX swap market: there was a substantial reduction of some HUF 400 billion in long forint positions. Simultaneously with this, however, non-residents' short positions in the forint fell further, which resulted in a slight decrease of some HUF 100 billion in their net position.

Non-residents' spot forint positions did not change significantly either, in line with developments in the FX swap market. This also contributed to the fact that the trend appreciation of the forint in April–May stalled: the exchange rate fluctuated around EUR/HUF 280, accompanied by slightly reduced but still significant volatility.

As the spot exchange rate stabilised around the EUR/HUF 280 level, the market revised up its expectations for the future level of the exchange rate compared with the previous month. This is suggested by the slight reduction in the negative skew of the implied distribution of expectations as well as by the results of the foreign exchange market survey conducted by Reuters at the beginning of the month. The consensus forecast of respondents to the poll is for the forint to be at EUR/HUF 285 on a one to three-month horizon, 280 on a six-month horizon and 275 on a twelve-month horizon. The path of the Czech koruna expected by analysts is broadly comparable with that of the forint. Respondents expect the Polish zloty and the Romanian leu to appreciate slightly even over the short term.

In a relatively stable financial market environment, risks to the stability of the banking sector declined, but did not vanish completely. The liquidity problems which emerged last October appear to have eased, and, moreover, the banking sector is currently maintaining strong liquidity levels. This situation is unlikely to change in the coming months, as the Debt Management Agency has recently indicated that the stock of outstanding government paper due to mature is higher than the amounts to be issued, and the financing gap thus caused is intended to be filled by IMF funds. All of this implies that domestic economic agents will not be able to reinvest their liquid funds from maturing government paper in government paper again, and, consequently, they will switch into bank deposits, further improving the sector's liquidity. Based on this information, banks' resilience to liquidity shocks appears strong.

It is important to note, however, that although the probability of liquidity shocks to the sector has fallen, it still cannot be neglected. Rolling over foreign funding continues to entail some risks. A rapid, large-scale depreciation of the forint, a faster-than-expected deterioration in the quality of banks' loan portfolios, a regional risk premium shock or a contagion transmitted through the subsidiaries of domestic banks may cause a sudden and significant liquidity shock.

Hungarian credit institutions have continued to cut back lending in recent months, as economic agents increased their deposits, with the result that banks' loan-to-deposit ratios have fallen. Reduced willingness to take risk or a stronger-than-expected increase in domestic agents' propensity to save rather than a deterioration in liquidity may be behind this adjustment in the banking sector. All of this may lead to a greater degree of adjustment in the real economy, i.e. a lower current account deficit, than expected, but it may also aggravate the current economic downturn. So far, the deterioration in the quality of banks' portfolios has been largely as expected; however, there is a significant risk that this deterioration will be even more severe, which, in turn, may accelerate the adjustment process in the banking sector.

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

Monetary Council members agreed that, in the current benign inflationary environment, the sustained improvement in financial market conditions and the reduction in Hungary's vulnerability had recently contributed to a gradual increase in room for manoeuvre in monetary policy.

Members judged that the underlying trends in the domestic economy and the outlook for inflation continued to present no obstacles to cautious policy easing in the future. Based on the latest foreign trade and household saving data, adjustment by the domestic sectors had proceeded more rapidly than previously expected, and, consequently, the country's external vulnerabilities had declined. Members thought that despite the temporary inflationary effects of the May CPI data, which were surprising on the upside, and the tax changes, inflation might remain around the Bank's inflation target over the medium term. On another argument, prices of certain wholesale supermarket chains did not confirm the adverse outcomes for inflation reflected in the official consumer price index data.

Several members noted that emerging markets had shown signs of stabilisation, as suggested by exchange rate and risk indices as well as measures of risk premia. It was also argued that exchange rate expectations had become more symmetrical recently, according to the results of polls of economists and market price data. Several members pointed out that official interest rates had been reduced in a couple of countries with similar measures of risk sentiment to those of Hungary, which may have increased the room for monetary policy manoeuvre. Others, however, warned that despite the easing in tensions, the problems facing Latvia had not yet been fully overcome. On another argument, foreign currency funding and the increase in the central bank's liquidity arising from sterilisation operations could have a negative influence on sentiment.

Monetary Council members agreed that the fiscal measures announced recently by the Government could help place the Hungarian economy on a sustainable path. However, due to the domestic political risks, sentiment towards the country was improving only gradually and the results of the adjustment could only be evaluated accurately at a later date. Members judged that in order for fiscal and monetary policies to achieve better outcomes it was necessary to restore the smooth functioning of the government securities market. It was also argued that despite the decline in the external financing requirement Hungary's reliance on external funding was not falling at an adequate rate, given the switch into foreign investments by pension funds traditionally purchasing Hungarian government securities. Taken together, the national economic policy institutions involved should cooperate more closely in order to alleviate tensions in the government securities market and deal with financing problems. Some members noted that the IMF was expected to approve the disbursement of another tranche of the stand-by facility soon, which would reduce the country's short-term financing problems.

Council members agreed that, based on the current outlook for inflation and the economy, an easing of policy was worth considering. The majority of members thought that if no significant correction occurred in the financial market, monetary policy could be eased even over the short term, but a great deal of caution and gradualism was required in implementing such moves, taking account of the risks to financial stability. Several members warned that interest rate cuts were conditional on approval by Parliament of the Government's proposed fiscal measures and an easing of tensions in the government securities market. On another argument, market participants should be made aware in advance of those central bank actions and surprise policy moves should only be made in particularly justified cases.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Six members voted to leave the base rate unchanged and three 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%	**6**	Csaba Csáki, Ilona Hardy, Ferenc Karvalits, Júlia Király, Judit Neményi, András Simor
In favour of reducing the base rate to 9.00%	**3**	Tamás Bánfi, 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 27 July 2009. The minutes of that meeting will be published at 2 p.m. on 12 August 2009.