MINUTES

OF THE MONETARY COUNCIL MEETING

OF 27 JULY 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 June 2009, annual CPI inflation increased by 3.7% and core inflation by 3.2%. Neither measure was significantly different from its value in the previous month. The higher outturns for the consumer price index in May–June were associated mainly with items excluded from the core inflation measure (e.g. unprocessed foods and petrol). Core inflation has remained stable around 3% over the recent period; however, the month-on-month rate of increase, better capturing developments in trend inflation, was close to 5% for the third consecutive month. Within the components of core inflation, the outturn for services price inflation was broadly consistent with the seasonal characteristics of the series for the month, with the annual index remaining below 4%. Tradables price inflation moved in line with the expected effects of exchange rate depreciation, with no outlying price changes observed.

Changes in some volatile price components resulted in a higher path for inflation in 2009 Q2: CPI inflation was 3.6% and core inflation 3.2% in the period. The former rose by 0.6 percentage points and the latter edged down by 0.1 percentage point compared with the previous quarter. Although the path for core inflation in Q2 is well explained by the fact that the effects of exchange rate depreciation were passed through more quickly to consumer prices than the effects of the negative output gap, there were few signs of a material fall in inflation of market services prices less affected by movements in the exchange rate in the period.

The actual core inflation figure was broadly consistent with the projection in the May issue of the *Quarterly Report on Inflation*; however, the overall price index exceeded it by 0.5 percentage points. The reason for this difference was the stronger-than-expected rise in unprocessed food prices. This represents an upside risk relative to the path for inflation presented in the May *Report*. Looking ahead, the fact that indirect taxes are increased at a time when inflation in Hungary is running at a faster pace than would be consistent with price stability adds to upside risks to inflation over the longer term.

Private sector gross average earnings rose by 4.3% and regular pay by 5.3% in May 2009 compared with the same period of the previous year. Earnings growth in the sector edged back slightly after slowing at the beginning of the year; however, it remained below the averages of previous years. Regular pay growth in manufacturing and market services indicated a similar picture, with the former being around 4% and the latter by around 6% in recent months. Significant, one-off factors related to bonus payments caused the paths of gross average earnings growth in the two sectors to diverge: in manufacturing higher bonus payments did not occur in May, as would have been typical, while significant bonus payments were made in the financial sector. However, the picture of earnings developments is altered slightly by the fact that the rate of wage growth of total employees may differ significantly from that of full-time employees, due to an increase in the share of part-time employees within the total. According to seasonally adjusted data, the number of employees in the private sector continued to fall slightly, in contrast with the total economy, where the number of employees rose by some 10,000 relative to the previous month, owing to increased public sector job opportunities created by the Government's 'Pathway to Work' programme. Overall, labour market adjustment has been weaker than expected based on the data.

The cyclical position of industry did not change materially in May 2009 compared with the previous month. Although the annual indices continue to reflect a sharp decline in performance, industry has been in a state of near stagnation since the beginning of the year on a month-on-month basis. Industrial exports rose slightly, while domestic sales fell, due to

declining demand and one-off effects from the energy sector.

Retail sales continued to fall in May 2009. Their volume, excluding the sales of passenger cars and components, dropped by 4.2%, with a decline of 8.4% in total retail sales volumes compared with a year earlier. There was a generalised decline across the various product groups; however, sales of consumer durables, and passenger cars in particular, fell sharply.

The trade account recorded a surplus of around EUR 1.5 billion in the first five months of the year. However, a slightly different picture is painted by the fact that some half of this surplus was related to VAT residents carrying out no actual business activity in the territory of Hungary and some quarter may be attributed to a lag in natural gas imports relative to the average of previous years. Nevertheless, the volume of goods exports began to increase in the period January–April, which is a positive development for external balance. The country's terms of trade improved slightly, accompanied by simultaneous declines in export and import prices.

In 2009 Q1, the current account deficit was lower compared with both market expectations and the Bank's forecast based on preliminary monthly data. According to seasonally adjusted data, Hungary's external financing requirement fell to the equivalent of 4.2% of GDP. The effects of the necessary adjustment by the domestic sectors were already clearly reflected in the various measures of external balance. In addition to improvements in the real economic balance and the income balance, Hungary received substantial funds from the EU, which played a dominant role in the improvement in external balance.

Financial market developments and the vulnerability of the banking sector

Assessments of risks associated with the Hungarian economy have improved overall in recent months; however, financial market developments remained volatile and investor sentiment towards Hungary fragile. Despite the improvement in assessments of Hungary's fundamentals, there remained risks to external and internal balance, which contributed to the latter, in addition to the uncertain global market environment and mixed developments in the economies of the region. The Hungarian CDS spread fell from levels close to 400 basis points to 305 basis points in the month; however, there was some deterioration in sentiment towards the country relative to the region.

Recent developments in the government securities market have been largely favourable. The auctions of government securities were characterised by high demand and falling auction yields; and the Debt Management Agency was able to raise significantly the amounts issued at the bond auctions. Hungary managed to raise new capital in a successful foreign currency bond issue. In the secondary market, yields fell at the shorter end of the yield curve, particularly at maturities beyond one year.

Foreign investors' demand for Hungarian assets picked up. Non-residents were net buyers in the government securities market in July: their government securities holdings have risen by some HUF 100 billion since the last interest rate policy decision. The larger part of this amount was related to purchases of government bonds; however, there was also an increase at shorter maturities. Non-residents' net outstanding FX swaps fell by HUF 230 billion, the larger part of which was attributable to the further reduction in speculative positions against the forint; however, the increase in their outstanding long positions in FX swaps vis-à-vis the forint also contributed to this.

The forint exchange rate moved in a fairly wide range of some HUF 15 in the past month. However, the band within which the currency fluctuated shifted down from EUR/HUF 275–290 and the exchange rate stabilised within EUR/HUF 270–280. At the same time, expectations of an appreciation were growing: in the poll conducted by Reuters in early July,

the consensus forecast shifted towards a stronger exchange rate at every horizon. According to the results, economists do not expect the forint to depreciate significantly over a one-year horizon, rather, they expect the exchange rate to remain within the above band for a prolonged period. In addition, the slight reduction in the negative skew of the implied distribution of expectations continued, falling to a level last seen in October 2008. Implied volatilities also fell slightly.

Both market prices and economists' forecasts suggest that expectations of an interest rate cut intensified in the past month. But, in contrast with previous months, expected movements in the forint exchange rate were a less dominant factor in explaining the size of interest rate change priced into the market. Based on the above and analysts' commentaries, it can be assumed that market participants view the exchange band of EUR/HUF 270–280 as a 'comfort zone' which allows the Bank to reduce the weight of risks to financial market in its interest rate decisions. An interest rate cut of 50 basis points at the Monetary Council's next meeting is priced into FRA quotes, with a cumulative interest rate reduction of 125 basis points over the period three to six months. Consistent with this, a 225 basis point reduction is priced into the interbank market yield curve over a one-year horizon. That corresponds to a 100 basis point reduction compared with the value prior to the interest rate decision last month.

According to the surveys conducted by Reuters and portfolio.hu, economists almost unanimously expect a 50 basis point reduction in official interest rates. A 50 basis point reduction is expected by 24 of the respondents to the Reuters poll, three expect interest rates to remain on hold and one analyst expects a 25 basis point reduction. In the survey by portfolio.hu, one analyst expects that interest rates will be left unchanged, another expects a 75 basis point reduction and 12 expect that interest rates will be lowered by 75 basis points.

Hungarian banks' liquidity position improved further. Participants of the sector have large liquidity surpluses, held mainly with the central bank. However, due to the narrow interest rate corridor and banks' high liquidity surpluses, turnover in the interbank market is low.

FX market liquidity is also judged to be adequate. There is a marginal difference between implied forint yields and interbank rates. In addition, banks are able to enter into FX swaps with increasingly longer maturities. Their recourse to the MNB's swap facilities has fallen recently, due to a reduced reliance on swaps, on the one hand, and an improvement in market liquidity, on the other.

The reduction in reliance on swaps resulted from adjustment through the demand for credit by the private sector and through the supply of credit by banks. In addition, despite the ongoing outflow of foreign funds, the stock of banks' foreign currency liabilities has been rising, due to inflows into private sector foreign currency deposits and lending by the Government to banks not owned by a foreign parent. This, in turn, also acts to reduce the need for banks to conduct swaps. The steady outflow of foreign funds is not country-specific: it is a factor characterising the entire region, explained by the slowdown in activity and an easing of the crisis. The stronger-than-expected propensity of private sector firms to save foreign currency deserves special mention, suggesting that companies' net financing requirement may be lower than earlier projected.

The solvency position of Hungarian banks – the most important factor from the perspective of financial stability – has also improved in recent months. Bank's favourable profitability, adequate capital position and capital increases announced by a couple of banks act to reduce risks. The remaining high interest rate margins and the positive revaluation of their government securities holdings offset the effects of the impact of increased provisioning for doubtful loans. The appreciation of the forint exchange rate has reduced households and firms' debt repayment burdens and the positive exchange rate effect has raised the banking

sector's average capital adequacy ratio. These factors also contribute to a reduction in solvency risks.

However, the further deterioration in the quality of banks' loans portfolios suggests that significant solvency risks remain. Currently, their level is in line with expectations, but a deeper or more protracted downturn than expected may speed up or prolong this process through a decline in incomes and employment. In the current situation, risks to economic activity are presumably higher than the liquidity and solvency risks stemming from exchange rate depreciation.

To summarise, the improvement in investor sentiment and better assessments of risks associated with the Hungarian economy contribute to maintaining the stability of the domestic banking sector. However, the financial system is still vulnerable, the primary reason being that risks to banks' solvency position, though falling, remain high.

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

Monetary Council members agreed that, in the current recessionary environment, the Bank's 3% target for inflation was likely to be met on the horizon relevant for monetary policy. The improvement in the domestic macroeconomy, global financial market developments and market participants' expectations made it possible to ease monetary policy.

Members judged that, based on the latest information, economic activity and inflation could evolve in line with the path presented in the May issue of the *Quarterly Report on Inflation.* In the current recessionary environment, a negative output gap and below-target inflation could be expected over the medium term. Some members pointed out that although previous episodes of exchange rate depreciation might contribute to an increase in the general price level in the future, this was very likely to be offset by the sharp decline in domestic demand. Others warned that the preconditions for sustained price stability were a moderation in services price inflation over the longer term and a stabilisation of inflation expectations at lower levels.

In assessing the latest macroeconomic developments, several members noted that foreign trade and current account data pointed to continued, significant adjustment by the household and corporate sectors. However, firms' financing position had deteriorated by less than expected, which may have been related to a narrowing of investment opportunities. Some other members pointed out that the adjustment in the corporate sector appeared somewhat slower than expected, according to available wage and employment data. And one-off factors, including the effect of lower gas imports compared with previous years, which, however, might have an opposing effect during the latter part of the year, may have played a role in the improvement in the current account at the beginning of the year.

Council members judged that assessments of risks associated with the Hungarian economy had clearly improved, due mainly to an improvement in investor sentiment globally and regionally and, to a lesser extent, to changes in the country's fundamentals. Several members pointed out that significant changes had occurred in the government securities market in the past month. The successful government bond auctions and a foreign currency bond issue by the Debt Management Agency had created an opportunity to finance the country from the market. On another argument, the improvement in foreign investor sentiment had also been supported by the adoption by Parliament of the Government's proposed tax changes, as they had created the conditions for meeting the deficit target and reducing interest rates.

In assessing the latest government securities market developments, some members warned that the turnaround in the primary market had not yet been reflected in the secondary market, where liquidity had not yet risen decisively. Several members stressed that the significant fall in CDS spreads, the sustained forint appreciation and the reduction in volatility indicated an improvement in investor sentiment. However, it was also argued that, compared with other countries of the region, Hungary's relative assessment had not improved materially.

Members agreed that the conditions for easing monetary policy had been created in the past few months, taking into account the outlook for economic activity and inflation as well as recent financial market developments. The market was now prepared for the interest rate cut, not least because of the MNB's communications. In addition, several members noted that decelerating the decline in real economic activity, preventing a further narrowing of credit supply and easing the conditions for forint lending also made it necessary to reduce interest rates. Members also agreed that if no significant deterioration occurred in international and domestic fundamentals, interest rates could be reduced substantially from their current level by the end of the year, as assessments of risks continued to improve.

However, there was a division of views over the issue of the timing of interest rate cuts. The majority of members preferred a larger-than-usual reduction in the base rate as an adequate monetary policy reaction to the recent particularly favourable developments. These members, among others, argued that they had seen scope for a 50 basis point reduction at the June policy meeting and the number of arguments in favour of a policy easing had increased since then. Several members warned that political uncertainty could be rising from the autumn, and, therefore, the Council should take advantage of the additional room for monetary policy as fast as possible. On another argument, excessively tight monetary conditions were at least as disadvantageous for the economy as excessively loose conditions. Some members noted that, due to the interest rate reductions in emerging countries, the Hungarian interest rate spread had increased in relative terms; the easing cycle had already reached its bottom in the majority of countries, and, therefore, the Council should not delay in taking advantage of the increased room for manoeuvre, given that it would be beneficial if Hungarian monetary policy was synchronised with international monetary trends. Other members argued that the Bank should implement interest rate cuts more cautiously and in smaller steps, its actions should be predictable and it should prevent an overshooting of interest rate expectations. Some other members argued that reducing rates cautiously and in smaller steps would facilitate a larger cumulative reduction in interest rates on the longer horizon.

Council members agreed that the size of a 100 basis point interest rate reduction did not provide any guidance in respect of future interest rate moves and the Council should seek to ensure that market expectations were guided by the Bank's interest rate moves.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Four members voted to reduce the base rate by 100 basis points, one member voted for a 75 basis points reduction and two members preferred a 50 basis point reduction.

Votes cast by individual members of the Council

In favour of reducing the base rate to 9.00%	**2**	Ferenc Karvalits, András Simor
In favour of reducing the base rate to 8.75%	**1**	Péter Bihari
In favour of reducing the base rate to 8.50%	**4**	Tamás Bánfi, Csaba Csáki, Ilona Hardy, Judit Neményi

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

Tamás Bánfi
Péter Bihari
Csaba Csáki
Ilona Hardy
Ferenc Karvalits
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 24 August 2009. The minutes of that meeting will be published at 2 p.m. on 16 September 2009.