MINUTES

OF THE MONETARY COUNCIL MEETING

OF 28 SEPTEMBER 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 August 2009, annual CPI inflation was 5.0% and core inflation was 5.1%, with both measures down 0.1 percentage point on the previous month. The August figure was lower than anticipated for the second consecutive month, as a result of two factors. First, based on available data, firms appear to have raised prices by significantly less than the technical effect of the VAT increase. This suggests that the disinflationary effects of the subdued domestic demand are becoming increasingly evident. Second, developments in unprocessed and processed food prices contributed significantly to the better-than-expected inflation outcome. The surprise decline in food prices was also seen in the August data in several countries in the region. The lower-than-expected impact of the tax increase and the drop in unprocessed food prices clearly point to downside risks to inflation over the short term relative to the Bank's current projection.

In the detailed release by the CSO, Hungary's GDP contracted by 7.5% in 2009 Q2 (7.4% after adjusting for calendar effects) relative to the same period of the previous year. According to quarterly trend indicators, gross domestic product fell for the fifth consecutive quarter, but the decline relative to the previous period suggests that the economy may have passed its sharpest rate of economic contraction in Q2. Available data indicate that, following the precipitous drop in external demand, the output performance of the export sector is stabilising at a low level. The decline in lending activity, procyclical fiscal policy and labour market adjustment continue to have an effect on developments in domestic expenditure components.

The volume of whole-economy investment fell by 4.7% in 2009 Q2 compared with the same period of the previous year. Weak performance of manufacturing, and particularly the substantial drop in machinery investment, was the main driving force behind this decline; fixed capital investment by the narrowly defined public sector also continued to fall. Presumably owing to transfers from the European Union, however, investment in the agriculture sector rose. Moreover, real estate activities, most closely related to household residential investment, performed remarkably well in the first half.

Industrial production and sales fell by 19.4% and 18.1% respectively in July 2009 compared with a year earlier. While export sales have picked up somewhat in recent months in response to a slight improvement in external demand conditions, the upturn in domestic sales in June appears to have been only temporary, and may be related to households bringing consumption forward, due to the VAT increase.

The trade account again registered a large surplus of EUR 374 million in July 2009 (adjusted for seasonal effects and VAT residents). Exports rose and imports continued to fall, following the sharp pick-up in June related to consumption brought forward due to the VAT change. The detailed data suggest that the rise in the value of goods exports since the beginning of the year has been driven in part by exports of agricultural goods. The smaller-than-expected drop in exports as measured by GDP may have been explained by the more modest decline in exports of services. And the stronger-than-anticipated decline in the volume of imports may have been related to falling specific import needs of exports, due to a change in the pattern of exports.

In July 2009, whole-economy gross average earnings were up 1.4% on the same period of the previous year. Private sector earnings grew by 4.7% and government sector earnings fell by 5.9%. The slowdown in the rate of earnings growth was observable in the case of both regular and irregular pay, but there were substantial differences in developments at the sector level. In manufacturing, earnings growth picked up slowly following the correction in the beginning of the year, while in market services earnings growth slowed steadily.

As regards numbers in employment, the previous rapid increase in the number of unemployed slowed in Q1, according to the Labour Market Survey, with the unemployment rate rising by 0.3 percentage points to 9.7%. In a sectoral breakdown, the fall in the number of private sector employees was offset by an increase in government sector employment, closely related to the 'Pathway to Work' programme.

Financial market developments and the vulnerability of the banking sector

Financial markets

Perceptions of risk associated with the Hungarian economy continue to be driven mainly by shifts in global investor sentiment, although there have been a number of supportive country-specific factors recently, in addition to the increase global risk appetite. Following a temporary increase, the high Hungarian CDS spread has fallen from 240 basis points to 210 basis points since the Monetary Council's interest rate decision in August. There was a generalised decline in CDS spreads across emerging markets, with a slight deterioration in Hungary's position in this respect. Reflecting the fragile nature of the decline in risk perception, the 5-year forward premium 5 years ahead vis-à-vis the euro calculated on the basis of interest rate swaps (which serves as a reliable guide to assessments of long-term fundamentals) fell only slightly over the past month.

In the primary market for Hungarian government securities, auctions continued to be characterised by strong demand and significant oversubscription, as well as by sharp falls in auction yields. In the secondary market, yields declined by 100–110 basis points at short maturities and by 70–100 basis points at maturities between 3–10 years. The fall in the 15-year benchmark yield was less sharp, amounting to approximately 40 basis points. Short-term benchmark yields are currently below 7%, while yields at maturities beyond one year are ranging between 7.3%–7.8%. However, the favourable picture painted by developments in yields looks slightly different due to a number of factors. First, the fall in yields in the government securities market may have been caused by reduced issuance of government debt. However, the Government's borrowing requirement from the market may increase significantly next year, which raises uncertainty about whether the fall in yields will be sustained. Second, secondary market turnover has been fairly low and non-resident investors' demand for domestic government securities has remained subdued.

According to the Reuters survey of economists, expectations are for the forint exchange rate to fluctuate between EUR/HUF 270–275 over the next year. Implied volatility has fallen further in the past month, and negative skewness calculated on the basis of options prices has remained at low levels since the summer. Based on the above, the effects of the optimistic global mood and positive domestic news have been increasingly reflected in developments in yields, rather than an appreciation of the exchange rate. However, the latest analyses, published in the wake of a sharp increase in expectations of interest rate cuts, have emphasised the risks associated with the high amounts of debt, in addition to the benign developments in the domestic and external balance, which, in turn, may continue to add to the vulnerability of the forint.

Interest rate expectations

In the past month, expectations of interest rate cuts, as reflected in market prices and economists' forecasts, intensified further significantly. Cumulative interest rate reductions of 100 basis points at the Monetary Council's next two meetings and of 175 basis points over a

3–6 month horizon are built into FRA rates. Based on the interbank yield curve, the central bank base rate may fall to 7.25% by the end of the year and to 6.25%–6.5% by the end of 2010, which implies a 25 basis point drop and a 50 basis point drop respectively, relative to the values expected last month.

Respondents to the Reuters poll unanimously expect the interest rate easing cycle to continue. The majority of economists (24 of 27) expect the Council to reduce rates by 25 basis points at the September policy meeting, with only three analysts expecting a larger interest rate cut. All of the 18 analysts polled by portfolio.hu expect interest rates to be reduced by 50 basis points at the next meeting. The median forecasts for interest rates at the end of this year and the next are 7% and 6% respectively.

The banking sector

The domestic banking sector's rapid adjustment to the new financial and macroeconomic environment continued. Due to the decline in owners' risk appetite and reliance on internal funding, reducing loan-to-deposit ratios and RWA is of prime importance for banks. The demand-side adjustment of the private sector and the supply-side adjustment of the banking sector led to a further decline in the outstanding debt of the corporate sector and to stagnation in that of the household sector in August. Meanwhile, deposits continued to rise, but this was caused almost entirely by an increase in, and a rearrangement of, household savings. As a significant part of the adjustment involves foreign currency on both the loan and deposit sides, the banking sector's demand for FX swaps also fell.

Restoring financial markets to normal operations contributed significantly to an improvement in the liquidity position of the Hungarian banking sector. There were significant improvements in the operations of the key financial markets, i.e. the spot foreign exchange, FX swap, the interbank and the government securities markets. Bid-ask spreads fell in all four markets, indicating an improvement in liquidity. Except in the spot foreign exchange market, bid-ask spreads returned to the low levels seen before October 2008.

Based on data available up to August, the deterioration in the quality of household and corporate sector loans continued. The provisioning needs of the private sector have increased steadily over the period since the beginning of 2009, both in nominal terms and as a percentage of the outstanding total. Compared with 1% in 2008, provisions for loan losses amounted to 2.2% in August 2009 and are expected to peak at around 3% at the end of the year. Based on the data, the deterioration in portfolio quality has so far been in line with the Bank's expectations.

The banking sector's profitability fell slightly, due to an increase in the costs of risk. The decline in profitability, however, was not nearly as sharp as would have been justified by the large amounts of loan loss provisioning. High profits earned by banks can be attributed to one-off items (e.g. profits from financial transactions), rather than to permanent revenues from normal banking operations.

The banking sector's capital strength (and its shock-absorbing capacity) increased further, with the capital adequacy ratio at nearly 13% in July, a high value by international standards. To summarise, the sector's shock-absorbing capacity improved further, due to better-than-expected bank earnings and increasing capital adequacy.

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

Monetary Council members agreed that in the real economic environment characterised by subdued demand, inflation might drop below the Bank's 3% target over the medium term. After considering the outlook for inflation and growth as well as financial stability issues, members unanimously thought that it was both possible and necessary to reduce the central bank base rate.

In the Council's judgement, domestic economic growth was consistent with the projection in the August issue of the *Quarterly Report on Inflation.* Nonetheless, it could not be ruled out that the domestic adjustment would turn out to be stronger than currently expected and that external demand would improve more rapidly than assumed in the Bank's earlier forecast. Referring to consumption and retail sales data, several members noted that in the economic environment characterised by subdued demand, inflation might continue to fall on the horizon relevant for monetary policy.

In assessing the latest inflation developments, several members warned that the disinflationary impact of the output gap had been weaker than expected and the risk of undershooting the inflation target had increased. Some members though that, based on the data for the past few months, there had been a shift in the future path of inflation toward lower levels relative to the August *Report* projection. On another argument, the pass-through of the VAT increase had been surprisingly weak in recent months, pointing to stronger restraints on price rises in trade and production than previously thought. Some members were of the view that other, one-off factors beyond the scope of monetary policy, in particular developments in unprocessed food prices, may also have contributed to the lower-than-expected price index data for August. It was also argued that in the current recessionary environment the adjustment of the economy to low inflation was only gradual. In order to stabilise and maintain low inflation, it was necessary for the aim of monetary policy – namely for the Bank to react to an increase in inflation risks when the prospects for growth were improving – to be credible for market participants.

Monetary Council members agreed that the global financial market environment had stabilised further, risk appetite had picked up and stability risks had diminished compared to earlier stages of the financial crisis. For several members, the substantial fall in yields on forint-denominated assets and CDS spreads suggested an improvement in risk sentiment.

Several members emphasised that Hungary's financing requirement was falling and the balance sheet of the banking sector was adjusting to the new environment that had evolved in the wake of the financial turbulence. Some members noted that stability risks had been transformed, liquidity and rollover risks had eased, while the likelihood of solvency problems had increased. Others warned that there could also be a reversal in the recovery in financial market conditions.

The considerable improvement in investor sentiment towards Hungary and the fact that investors regarded the country's overall financial position to be much more favourable were viewed as positive. The fall in government securities yields provided evidence of improvement in investor sentiment; and the increase in demand for government securities following the change to the pension fund regulations might contribute to further improvement in conditions in the government securities market. Several Council members pointed to analyses by foreign investment banks, which judged the prospects for the Hungarian economy as being much better than they previously were. However, members also pointed out that despite analysts' favourable assessments the share of non-residents' holdings had not yet increased based on government securities statistics. Some members warned that an increase in the share of domestic financing was still needed in order to achieve an improvement in economic balance, but noted that a pick-up in non-resident investors' activity would be required for a sustained increase in liquidity in the government securities market.

It was agreed that there was scope for a reduction in the central bank base rate within the framework of the inflation targeting regime, even within its version augmented by financial stability issues. Some members judged that – based on the latest information – market participants expected marked but not excessive reductions in interest rates. Several members stressed the importance of predictable monetary policy and argued that an interest rate policy of cautious cuts and the instrument of interest rate smoothing by the central bank might support a desired further reduction in volatility.

Monetary Council members agreed that with the easing in financing stability risks, monetary policy could rely more on the inflation targeting regime over the short term; however, the fact that analysing financial stability risks had increasingly become part of monetary policy decision-making compared with the period prior to the crisis represented a lasting change. On another argument, the Bank's room for manoeuvre had been limited strongly by the situation in world financial markets. Price signals by the central bank were less effective in periods of optimistic risk taking or crisis situations, when market sentiment and quantitative barriers strongly affected market adjustment. If conditions in financial markets stabilised further, this would make it easier for the Council to make policy decisions.

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

Votes cast by individual members of the Council

In favour of reducing the base rate to 7.50%	**8**	Péter Bihari, Vilmos Bihari, Csaba Csáki, Ilona Hardy, Ferenc Karvalits, Júlia Király, Judit Neményi, András Simor
In favour of reducing the base rate to 7.25%	**1**	Tamás Bánfi

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 19 October 2009. The minutes of that meeting will be published at 2 p.m. on 4 November 2009.