MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 25 JANUARY 2010

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

According to the CSO, in December 2009 annual CPI inflation was 5.6% and core inflation was 4.8%. CPI inflation rose by 0.4 percentage points and core inflation fell by 0.2 percentage points relative to the previous month. As was the case in November, the increase in overall CPI inflation reflected base effects from the significant decline in motor fuel prices last December.

Looking at movements in prices in the core inflation measure, annual services price inflation remained at historic lows, but no further decline occurred in December. Largely as a result of subdued domestic demand, services price inflation is expected to continue falling, but this is only likely to initially appear in the January 2010 index, due to the timing of price changes within the year. Tradables prices continued to reverse some of the sharp decline in October on a month-on-month basis. At the quarterly frequency, however, the trend reversal which occurred in the middle of the year is more discernible, reflecting the disinflationary effects of the stronger exchange rate and weaker domestic demand. Processed food prices were flat, suggesting that the fall in inflation observed in the second half of 2009 might be nearing its end.

Following the temporary surge in response to the indirect tax increases, sustained low inflation is expected from 2010 H1 on the horizon relevant for monetary policy.

The aggregate picture continues to mask two diverging trends in real economic activity. While the sharp decline in domestic absorption continues unabated, sectors producing for exports are in a somewhat better position. The November data, however, may show the first signs that the recovery in activity in Europe is losing momentum.

The value of retail sales fell to a new low in October 2009: narrowly defined sales dropped by 7.5%, with total sales declining by 13.2%. Falling real wages, rising unemployment and low borrowing for consumption accounted for the fall in the volume of retail sales to a historic low, with all of these factors prompting households to make more efforts to adjust their balance sheets. There was a generalised decline in sales, with the largest drop recorded in durable goods sales, and particularly in new car sales.

By contrast, the quarterly balance of payments data for 2009 Q3 turned out significantly better than expected by the market. The combined surplus on the current and capital accounts amounted to EUR 1,050 million, with Hungary's external financing capacity being the equivalent of nearly 5% of GDP, according to seasonally adjusted data. This meant that there continued to be a sharp improvement in external balance for the fourth quarter in succession. A closer look at the numbers suggests that the individual components of the balance of payments have continued to reflect the diverging trends observable in the real economy. Compared with the first half of the year, it was rising exports rather than declining imports that contributed to the trade surplus in this quarter. It should be noted, however, that the latest data, i.e. for November 2009, indicated a slowdown in the rate of export growth. The fall in investment income since the end of 2008, driven mainly by declining corporate earnings, continued.

After increasing in previous months, industrial production fell by 7% in November 2009 relative to the same period of 2008 and by 1.2% compared with October. Output fell across a broad range of industries. The fall in output was accompanied by declining sales, with the contrast between rising exports and falling domestic sales remaining. Although export growth in manufacturing has slowed in recent months, domestic sales have continued to fall markedly. European business survey indicators suggest that the effects on activity of stockbuilding by companies and governments' economic stimulus packages appear to be waning. Falling euro area imports and the slowdown in German industrial orders seem to reflect weakening external demand. The trade surplus in goods in November was about the same as in previous months of the year. It is noteworthy, however, that export growth slowed, in line with the downward correction in industrial production, whereas import growth continued to rise.

Whole-economy gross average earnings fell by 3.0% in November 2009 relative to the same period of the previous year. Within this figure, private sector average earnings grew by 3.8%, and government sector average earnings fell by 16.5%, on account of cuts in certain irregular pay components of remuneration. In the private sector, a higher index for regular pay explained most of the increase in earnings growth. Higher earnings growth in manufacturing was consistent with more favourable external demand conditions, unlike in market services, where the pick-up in earnings growth was somewhat surprising. The reduction in bonuses was much smaller than had been expected. On balance, however, there continued to be little inflationary pressure from the labour market, owing to historically low earnings growth and the sharp decline in employment.

Financial market developments and the vulnerability of the banking sector

Financial markets

Perceptions of risks associated with the Hungarian economy barely changed in the past month, according to the more important measures of credit risk derived from spreads. The five-year sovereign CDS spread fell from 242 basis points to 212 basis points by mid-January, and then rose again to 243 basis points towards the end of the period. These movements in the CDS spread were largely accounted for by global market trends: compared with other countries with similar risk profiles, there was no significant change in Hungary's assessment in relative terms. The spread over five-year euro forward rates five years ahead fell slightly from its level in December.

Concerns over the fiscal position in Greece remained highlighted, with the spillover effects of this clearly reflected in the spread measures of other peripheral euro area countries. Risks are expected to remain. This has had a negative impact on assessments of countries with high public debt and may have contributed to the indicators of risk associated with Hungary falling only modestly despite generally improving global investor sentiment. All this suggests that there has been a sustained shift in investors' risk perception in the wake of the problems in Greece.

Market analysts' forecasts for Hungary, published early in 2010, offer a very mixed picture. On balance, while part of the analyses seem to reflect the effects on Hungary's assessment of the improvement that has occurred so far in its economic fundamentals, another part of market analysts continue to place more emphasis on the remaining significant risks.

Yields in the secondary market of government paper have fallen since the Monetary Council's previous policy decision, which, contrary to earlier trends, has also been clearly reflected in movements in yields at the long end of the curve. Benchmark yields at maturities over one year currently stand at 7.0%–7.7%, after falling by some 25–30 basis points, while yields at maturities below one year have fallen to 5.75%–5.85%. The auctions held in the past month were successful: there was strong demand for government securities issued by the Debt Management Agency and auction yields fell. Moreover, the Agency was able to raise the offering amounts as the auctions were oversubscribed.

The forint exchange rate has continued to fluctuate within the EUR/HUF 265–280 range that has prevailed for the past six months. No material shifts occurred in exchange rate expectations: there was a marked reduction in the negative skewness in the distribution of exchange rate expectations calculated from option prices. In addition, a survey conducted by Reuters revealed that market economists expected the exchange rate to be stable on a one-year horizon. Historical and implied volatilities both fell significantly.

Non-residents' forint positions increased by some HUF 290 billion in January. At the same time, however, non-residents' demand for Hungarian government paper continued to show little sign of picking up: the sector's government securities holdings fell by HUF 30 billion in the month. In addition, non-residents reduced their holdings of MNB bills by HUF 25 billion. They used the domestic currency acquired by selling securities to reduce their FX swap positions: their net outstanding swaps fell by some HUF 380 billion.

The smaller-than-expected reduction in interest rates at the Council's December policy meeting led to a moderation in the market's interest rate expectations: participants interpreted the decision as indicating that the Council would continue to reduce rates at a slower pace than earlier. Over the course of the month, however, expectations of future interest rate cuts increased slightly in the wake of the improvement in sentiment worldwide. Based on FRA quotes, the market attaches equal probability to interest rates being reduced by either 25 basis points of 50 basis points at the Council's next meeting. By contrast, expectations for the low point of the easing cycle have not changed materially: the bottom of the interbank interest rate curve continues to be around 5.5%–5.75%, while the central bank base rate is expected to trough at 5.5%, according to analysts' commentaries.

The overwhelming majority of respondents to the survey conducted by Reuters expect the Council to reduce interest rates by another 25 basis points at its meeting in January. Twenty-three of the 27 economists polled regard that as the most likely outcome; 3 analysts expect a 50 basis point cut and one analyst expects interest rates to remain on hold. The median of expectations for the low point of the easing cycle has remained 5.5%, with the average falling by some 25 basis points to around 5.25%. The forecasts are dispersed between 4.00% and 5.75%.

The stability of the banking sector

As regards recent developments in the domestic banking sector, the weakness in bank lending poses one of the greatest risks to Hungarian economic performance. In December 2009, the decline in both corporate and household loans accelerated, according to preliminary data for the banking sector as a whole. Analysing the annual profile, lending to companies fell significantly, by more than 7%. That was high by international standards, and in the euro area, similarly sharp declines were recorded only in Greece and Ireland, and, in the CEE region, in the Baltic states and the Czech Republic. Also as a negative development, companies reduced their deposit holdings by the end of 2009, while the total amount of deposits households placed with banks was low. The slowdown in the inflow of deposits (due to the necessary decline in the still high loan-to-deposit ratio) may amplify the fall in lending. This process may be further aggravated if parent banks continue to deleverage their balance sheets and the European Central Bank withdraws its unconventional monetary policy instruments.

The Bank has revised down its projection for lending to the corporate and household sectors for two reasons. First, on the demand side, the decline in domestic sales have turned out to be sharper and more protracted than anticipated. Second, on the supply side, banks have continued to adjust.

Looking at the price terms of lending, interest rates on loans continued to fall in December 2009. As a an important development, however, the 6 percentage point interest differential between corporate forint and euro-denominated loans remained, while the differential between interest rates on household forint and euro mortgage loans narrowed to 2 percentage points. A number of banks have entered the forint-based mortgage lending market in recent months. The new forint-based facilities with much lower interest rates, linked mainly to 3–12 month benchmark interbank funding rates, have caused a significant decline in APR. We feel that this level is sufficiently low for households to treat forint-based mortgage loans with no exchange rate risk as a real alternative in their new borrowing decisions. In the case of existing loans, we expect a gradual switch away from foreign currency-based to forint-based borrowing, as the 1%–2% prepayment penalty adds to costs arising from the existing, though falling, interest differential.

In respect of the stability of the banking sector, the deterioration in the quality of the sector's loan portfolio and its downward effect on earnings deserve special note. According to preliminary numbers, the negative impact on banks' earnings of provisioning for corporate and household loans rose to 2.4% in 2009, which was less than the 3% increase expected earlier. This difference is mainly accounted by the significant rise in the ratio of restructured loans, which reduced markedly banks' liability to set aside provisions for impaired loans. This unexpected effect may be partly offset by a regulation in force from January 2010, which imposes stricter requirements on banks concerning the management of restructured loans and loan-loss provisioning. Preliminary data indicated that, despite high credit losses, the sector's pre-tax profits for 2009 were 10% higher than the end-2008 results, exceeding expectations. However, this favourable picture is altered by the fact that the market of banks with positive results is highly concentrated, while a number of participants of have low, and in many cases negative, profitability. Balance sheet adjustment by banks with low profitability may remain strong. This risk is aggravated by the fact that the sector's high profits were owing mainly to one-off items (e.g. income from financial transactions). For this reason, it is likely that the banking sector's earnings will fall considerably this year.

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

Monetary Council members agreed that in the current economic environment characterised by subdued demand, the outlook for inflation allowed the Bank to reduce the base rate further. The majority of members thought that developments in global financial markets reduced the scope for interest rate easing to continue at the pace of last year, even though such easing was justified by macroeconomic conditions.

In the Council's judgement, apart from the temporary effects of the indirect tax increases and some volatile components of price indices, no inflationary pressure had yet occurred in the economy, due to the sharp decline in domestic macroeconomic demand. In respect of the outlook for economic activity abroad, some members pointed out that the recovery in the global economy could be related to the fiscal stimulus packages of governments and there was a considerable risk that activity might slow significantly again once these measures run their course. Several members stressed that a turnaround in the world economy would require a new business and economic policy model which could mitigate the risks of financial imbalances and asset price bubbles.

Council members agreed that the markets' perception of risks associated with the Hungarian economy had barely changed in the past month. Although in early January positive changes had seemed to be underway (e.g. sharp falls in yields, exchange rate strengthening and large gains in share prices), market optimism had deteriorated in the past two weeks. Several members emphasised that looking at longer-term trends Hungary's assessment had improved significantly, due to macroeconomic stabilisation and improvement in financing conditions.

In discussing fiscal trends, several members noted that the deficit figure for 2009 had constituted a positive surprise and had a favourable impact on market sentiment. It was also argued that enhancing liquidity in the government securities market continued to be an economic policy challenge, as this could create an opportunity for foreign institutional investors to re-enter the market. Some members thought that Greece's and Dubai's debt problems could increase the costs for Central and Eastern European countries to service their debts in the medium term.

Considering the outlook for inflation and the economy, members of the Monetary Council were unanimous in the view that it was necessary to reduce interest rates further. In determining the size of the current rate cut, the majority of members argued that developments in perceptions of risks associated with the Hungarian economy did not allow for a reduction in interest rates of more than 25 basis points. Some members, however, noted that the latest macroeconomic data pointed to adverse developments in the economy which could lead to unduly rapid disinflation and, therefore, a 50 basis point interest rate reduction was warranted this month. Other members, however, thought that returning to the Council's earlier practice of reducing interest rates in steps of 50 basis points would mean undue volatility in monetary policy.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Six members voted to reduce the base rate by 25 basis points and three members voted for a 50 basis point reduction.

Votes cast by individual members of the Council

In favour of reducing the base rate to 6.00%	**6**	Péter Bihari, Vilmos Bihari, Ilona Hardy, Ferenc Karvalits, Júlia Király, András Simor
In favour of reducing the base rate to 5.75%	**3**	Tamás Bánfi, Csaba Csáki, Judit Neményi

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 22 February 2010. The minutes of that meeting will be published at 2 p.m. on 17 March 2010.