MINUTES

OF THE MONETARY COUNCIL MEETING

OF 29 MARCH 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

Incoming data confirm the view that inflation may fall below 3% in 2011. In February 2010, annual CPI inflation fell to 5.7% and core inflation to 4.8%. In accordance with earlier expectations, the fall in seasonally adjusted tradables inflation and the modest drop in food price inflation both contributed to overall inflation adjusting downwards in February, following the sharp increase in the previous month.

The outturn for services price inflation was largely in line with the projection in February's *Quarterly Report on Inflation*. As most prices are adjusted at the beginning of the year, the February data, which were lower than would have been expected based on past seasonal patterns, are consistent with the view that weak demand may have materially driven down services price inflation.

In January, the seasonally adjusted level of food prices rose, before falling back in the review month. Whereas the January increase in prices was spread across a wide spectrum, the drop in February was limited to a narrower range of products.

The latest data are consistent with the future path of inflation presented in the February *Report*. In the quarters ahead, depreciation of the euro against the US dollar may represent a risk, mainly due to rising oil prices.

Real economic activity continues to be shaped by the divergent trends of external and domestic demand. According to the latest CSO release, Hungary's gross domestic product fell by 4.0% in 2009 Q4 relative to a year earlier, the same as the preliminary estimate. The contraction of the Hungarian economy slowed significantly in the final quarter of last year, but the data still suggest that the recovery in the domestic economy is lagging behind that in the global economy and the countries of Central and Eastern Europe. One reason for this is domestic demand, which – although it was slightly better than expected – has remained weak.

Developments on the output side were varied. Industrial production continued to pick up, owing to favourable business conditions abroad. The output of market services and construction fell, however, due to the continued sharp decline in consumption and investment.

On the expenditure side, the decline in household consumption expenditure and gross fixed capital formation continued in the final quarter of 2009. By contrast, net trade once again made a positive contribution to GDP growth, in line with expectations of a modest recovery in external demand.

The decline in the volume of retail trade in January 2010 was less pronounced than in previous months. While the December data pointed to a sharp adjustment in household spending, the January data suggested that macroeconomic developments shaping household consumption may have improved.

In January, industrial production reversed the significant decline in December, slightly exceeding expectations. Growth was spread across almost every sub-industry within manufacturing, resulting in the volume of industrial production returning to the trend seen in previous months. Despite the favourable outturn for January, weaker-than-expected German production data and the ending of the car scrappage schemes in Germany both require caution in respect of the shorter-term outlook, and over the medium term the pick-up in economic activity is expected to be slow and fragile.

In January, the trade account surplus was on par with previous months. As was the case with

industrial production, the decline in foreign trade in December turned out to be short-lived, with export and import values returning to the trend of earlier months. Imports remained relatively flat at their earlier depressed levels. Consequently, the surplus on goods trade was broadly the same as in previous months.

A turnaround in employment is only expected towards the end of the year, as wage growth continues to be low. Gross average earnings in the total economy grew by 6.5% in January relative to a year earlier. Private sector earnings growth was higher than the whole-economy average, explained by a base effect in manufacturing sector earnings and the partial payment of bonuses in market services postponed from the previous year-end to early 2010. From a typical rate of about 8% in previous years, annual earnings growth in market services has slipped to below 4% in recent months. The high government sector earnings index was also closely related to a partial adjustment to bonus payments postponed from lasts year.

According to the CSO Labour Force Survey, the decline in employment observed since mid-2008 came to an end in 2009 Q4. The unemployment rate did not rise further in the final months of 2009, remaining steady at above 10% in H2. Overall, the number of people in employment was broadly consistent with earlier expectations. The unemployment rate is still unlikely to start falling before the end of 2010.

Financial market developments and the vulnerability of the banking sector

Financial markets

Developments in global money and capital markets have been mixed in the past month. Investors' attitude to stock indices, high-yielding currencies and emerging-country bonds is basically characterised by an increase in their appetite for risk. Positive macroeconomic releases from emerging economies and the United States, as well as information about the Fed's long-term commitment to maintaining loose monetary conditions have also contributed to this. In the euro area, the benign effects of broadly positive macroeconomic data have been overshadowed by the deterioration in perceptions of risks associated with Member States in a weaker fiscal position. In consequence, after falling initially, government securities yields and CDS spreads rose, and the euro depreciated against other major currencies. In Central and Eastern Europe, currencies appreciated on average by 1.5%–2.5% against the euro; and five-year CDS spreads fell by 50–60 basis points.

Perceptions of risks associated with the Hungarian economy improved by broadly as much as the average for the region, but this was reflected differently in asset prices. The five-year CDS spread fell to nearly 180 basis points from around 230 basis points in the second half of February, which, however, did not lead to a material change in the country's relative position. The spread of the five-year government bond over German Bunds of comparable maturity has fallen by about 10 basis points since the Monetary Council's last interest rate decision. This is less than the falls in spreads in neighbouring countries. The forint appreciated by some 2.5% against the euro, outperforming other currencies of the region. From around EUR/HUF 270 at the end of February, the forint strengthened to EUR/HUF 261, before stabilising in a range between 262 and 265. This meant that the exchange rate departed from the EUR/HUF 265–280 band prevailing since the middle of last summer. However, it would be difficult to explain the strength of the exchange rate purely on fundamental grounds. In addition, it must also be taken into account that turnover in the foreign exchange market has been much lower than the average in recent weeks. Exchange rate expectations have changed little: respondents to the poll conducted by Reuters in early March expect the forint to remain flat at levels as at the time of the survey in the short term, and to appreciate slightly on a one-year horizon. The implied volatility of the EUR/HUF exchange rate fell slightly. The skewness in the distribution of exchange rate expectations shifted slightly towards

depreciation.

Associated with significant exchange rate appreciation, the build-up of long forint positions by non-residents has continued apace in recent weeks. They have purchased more than HUF 370 billion in the spot market since the previous policy decision, of which they have used some HUF 150 billion to engage in FX swaps. Meanwhile, the increase in non-residents' holdings of Hungarian government securities slowed further, while their holdings of shares and MNB bills rose by a total of HUF 80 billion.

In the government securities market, yields fell sharply at both short and long maturities: since the February interest rate decision short-term yields have fallen by 50–60 basis points, with a decline of 70–100 basis points at maturities between five and ten years. There was a perceptible reduction in the record steepness of the yield curve. The auctions were basically successful: yields fell significantly, with many issues oversubscribed. As a favourable development, foreigners' demand for government bonds on offer at auctions continued to be robust, and secondary market liquidity improved strongly.

Based on FRA quotes, the market's interest rate expectations have undergone a material change since February. The bottom of the interbank interest rate curve expected by the market has shifted down by 50 basis points to the current 5.0%–5.25%. According to the survey conducted by Reuters, short-term interest rate expectations point to a further reduction in official interest rates. Expectations for the low point of the easing cycle have fallen, with forecasts ranging from 4.0% to 5.75%. Nearly half of the economists expect the current easing cycle to end in the next 2–3 months, and the majority of the rest expect it to end in 2010 H2.

The stability of the banking sector

Bank lending to the corporate sector continues to be subdued, and there are still no clear signs of a possible upturn.

As the Bank expected, total household debt continued to fall in the first two months of the year, with the fall in foreign currency loans explaining the larger part of the decline. Forint loan products continued to increase as a share of total lending, on account of the less than 2 percentage point difference between interest rates on new forint and euro mortgage loans. Within total new lending to households, forint loans account for around 45%, and their share within mortgage loans is below 30%. Considering the long maturity of mortgage borrowing, the 2 percentage point interest differential between forint and euro mortgage loans is still high, preventing a faster expansion of forint products in the market. Household deposits fell slightly.

From a financial stability perspective, it is important that the banking sector's loan-to-deposit ratio fell only slightly. This was consistent with the stagnation in banks' foreign liabilities and outstanding swaps. Provisions for loan losses stopped rising in January–February, and, moreover, the downward effect of provisions on earnings was slightly lower as a percentage of loans. Loss given default appears to be close to a turning point, as the Bank expected. However, there has been slow progress in the clean-up of household loan portfolios, due to the large amount of restructurings, and loss given default on loans has fallen only slightly. It requires caution when assessing banks' exposures that by restructuring non-performing loans and providing a temporary reduction or suspension of payments, banks are able to improve the solvency of customers and reduce losses on lending. After the grace period expires, however, the debt burden on households will rise significantly, possibly even above its level prior to restructuring. Debt restructuring, therefore, may alleviate pressure on banks' earnings in a transitory recessionary environment, but its benign effects do not materialise during a protracted downturn or a period of persistently low economic growth.

After recording unexpectedly high earnings in 2009, the domestic banking sector once again earned high profits in the first two months of 2010. This year, it is expected that banks will only be able to make up for the positive effect of one-off profits from financial transactions last year by increasing lending and widening interest margins. Banks have so far widened their margins on lending rather than increasing lending. All this has led to a reduction in existing customers' disposable income and ultimately their ability to consume and repay their debts. In consequence, household consumption is declining, in addition to subdued lending and high interest burdens.

The overall capital position of banks is adequate, with the capital adequacy ratio (CAR) at 12.8% in February 2010. Declining lending, the auditing of within-year financial results and capital increases by parent institutions were the major factors contributing to the improvement in the sector's CAR. The market share of banks with lower capital adequacy ratios of between 8% and 10% has fallen.

The banking sector's ability to absorb shocks has improved recently. The results of liquidity stress tests conducted by the Bank indicate that banks' liquidity buffers would be sufficient should a major disruption to the market, a potential run on deposits and an exchange rate shock occur simultaneously. At the same time, however, while it is lower than either at the end of 2008 or early 2009, banks' reliance on the FX swap market has remained; several of them may face a foreign currency shortage in the event that liquidity in the market dries up. In the baseline scenario, there is no need for capital increases in response to credit risk losses, due to the sector's high capital adequacy. Even in an extreme scenario, the need arising for banks to increase capital would be low and manageable.

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

Monetary Council members agreed that there had clearly been a reduction in investors' perceptions of risks in March, which made it possible for the Council continue the easing cycle justified by macroeconomic fundamentals. Further central bank actions would be decided in the light of the sustainability of the current improvement in conditions.

In the Council's judgement, data released since the last interest rate decision had not altered the projection in the February *Quarterly Report on Inflation*. The outlook was somewhat better in terms of final consumption; however, adjustment by domestic economic agents continued to be substantial, causing a sustained improvement in Hungary's current account balance. Discussing the real economic situation, some members noted the risk that, due to a lasting decline in capacity utilisation, factors of production might suffer greater damage, unemployment might rise on a sustained basis and output might trend upwards more slowly.

There was agreement among members that the inertia of pricing and wage-setting may have been reduced as a result of weak domestic demand. Several members, however, cautioned that imported inflation risks had risen, due to increases in energy prices and the appreciation of currencies playing a dominant role in energy trade.

Members agreed that there had been a clear, albeit previously unexpected, improvement in perceptions of risks in the past month. With the favourable changes in conditions in global financial markets, CDS spreads and government bond yields in Central and Eastern European countries had fallen, and exchange rates had appreciated. There was, however, a division of views about likely future developments in financial market sentiment. Several members noted that there had been a shift in assessments of risks associated with emerging and developed economies: sentiment towards emerging market economies had improved

following the increase in public debt in the developed world, which might suggest a more lasting change. But other members warned that this improvement involved a significant degree of uncertainty and that a future correction could not be ruled out. Several members stressed that – despite the improvement in investor sentiment – the problems of Greek government debt had not yet been resolved. On another argument, in the absence of fundamental capital flows, 'hot money' flows were generating changes in the prices of short-term instruments and CDS prices, and perceptions of risks associated with the Hungarian economy had not improved compared with other emerging market economies.

Members agreed that the improvement in perceptions of risks associated with the economy allowed for continuation of the policy of cautious reductions in interest rates in March. From a real economy and inflation perspective, it was desirable to continue reducing interest rates further; however, firm conclusions could not be drawn about the likely end of the current interest rate cycle. Some members thought that faster reductions in interest rates than in previous months deserved consideration, because a drawn-out easing cycle might increase the likelihood that regular speculation on interest rate cuts and undesired market anomalies would develop. Several members, however, argued that reducing interest rates in a sequence of small steps had proved to be the correct strategy in the past and might better facilitate achievement of the Bank's long-term monetary policy objectives. Some members reiterated earlier views that in setting monetary policy the risks of inflation projections departing from the target should be taken into account asymmetrically, as the risks of overshooting the target might be greater in terms of the central bank's credibility than the risks of undershooting it.

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 25 basis points and three members voted for a reduction of 50 basis points.

Votes cast by individual members of the Council

In favour of reducing the base rate to 5.50%	**4**	Péter Bihari, Ferenc Karvalits, Júlia Király, András Simor
In favour of reducing the base rate to 5.25%	**3**	Tamás Bánfi, Csaba Csáki, Judit Neményi

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

Bánfi Tamás
Péter Bihari
Csaba Csáki
Ferenc Karvalits
Júlia Király
Judit Neményi
András Simor

Tibor Erhart, Deputy Head of Department of the Ministry of Finance, was present as the Government's representative.

The Council will hold its next policy meeting on 26 April 2010. The minutes of that meeting will be published at 2 p.m. on 19 May 2010.