MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 26 APRIL 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 continue to indicate little or no risks to the short-term outlook for inflation on the upside. In March 2010, annual CPI inflation was 5.9% and core inflation was 4.7%. Inflation rose to 6.0% in the first quarter of 2010, but this was mainly related to the increase in excise taxes. In previous quarters, the quarterly trend rates of inflation remained below the Bank's inflation target.

Due to weak domestic demand, the March outturn for the services price index was significantly lower than the typical pre-crisis levels for this month. Tradables inflation was negative again in March. It appears increasingly likely that the high January outturn for this price index was caused by a change in seasonality. Consequently, little or no upward pressure is expected on tradables prices looking ahead. Food prices rose only mildly in the past month, remaining broadly stable over the first quarter of the year.

The March inflation data is consistent with the expectation that inflation may be below the medium-term target in 2011. On that horizon, however, the expected further rise in oil prices, the depreciation of the euro against the US dollar and continued high inflation expectations pose upside risks.

Over the short term, economic activity may be more robust than expected, but the medium-term outlook has not improved. Industrial production grew by 8.4% in February, falling slightly relative to the preceding month. Production growth has moderated in the previous months, probably because of the slowdown in the German economy. More recent confidence indicators, however, imply that economic activity in Germany may be beginning to pick up again. Fast growth in Asia may give a boost to European exports, which, in turn, may have a benign impact on Hungarian industrial production growth. Along with stronger-than-expected stockbuilding by companies, this poses upside risks relative to the assessment in the February *Report*. Intensifying concerns over the sustainability of government deficits, however, cast a shadow on the longer-term outlook for the world economy. These may force governments to implement earlier and deeper fiscal adjustment than previously expected. Therefore, the medium-term risks to Hungarian industrial production growth are mainly on the downside.

Hungary's current account registered a significant surplus of 4% of GDP in 2009 Q4. The real economic balance stabilised at a high level and the income account balance improved further, explained by lower net interest payments, in addition to declining corporate profits. The country's net external debt fell to 54% of GDP. Non-debt capital outflow was related to the consolidated general government (government securities and MNB bills). Net issuance of government securities was negative, and non-residents reduced their holdings in the secondary market, with a large part absorbed by the domestic banking sector. Banks' investment position vis-à-vis the rest of the world remained unchanged. Non-debt inflow was once again positive in 2009 Q4, but fell to a historic low in 2009 as a whole.

Foreign trade expanded further in February. The surplus on trade in goods declined in the past two months, but remained significant. The rate of export growth slowed somewhat, in contrast with that of imports which picked up further, presumably due to stockbuilding by domestic companies. The terms of trade improved in January, but may deteriorate during the remainder of the year, due to the likely further rise in commodity prices.

Earnings growth has been consistent with the projection in the February *Report*. Whole-economy earnings were 0.9% higher in February than a year earlier. Within this figure, private sector earnings grew by 4% and government sector earnings fell by 6.2%. The high year-on-year growth in private sector pay was caused by the unusually low growth in earnings during the previous twelve months. The monthly growth rate for earnings was subdued, in line with the Bank's expectations. The divergence in real economic performance has also been reflected in the labour market. Gross average earnings in manufacturing, which is more responsive to the strengthening of global activity, rose by 6% in February, in contrast with the roughly 2% increase in gross average earnings in market services, which has been more deeply affected by the weak domestic demand. These divergences in earnings growth are likely to remain throughout the remainder of the year.

The number of employees in the total economy did not change significantly in February as a result of two opposing influences. Whereas in the private sector – particularly in market services – employment numbers fell, in the government sector the number of those employed in public works increased slightly.

Financial market developments

Global economic conditions continued to be mixed: positive sentiment among investors in international markets was maintained, but uncertainty about Greece remained and even began to escalate in the latter part of the month. Markets in developed countries were generally dominated by investor optimism. Leading stock indices and commodities prices rose slightly, and measures of volatility in equity and foreign exchange markets as well as corporate credit default swap (CDS) premia remained at low levels. Four major factors contributed to global optimism: i) the improving macroeconomic outlook in developed countries, ii) stronger expectations of a prolonged period of loose monetary policies, iii) the negligible impact on the market of the withdrawal of some liquidity-enhancing measures, and iv) better-than-expected corporate earnings reports for the first quarter. In terms of the global real economic outlook, however, the sustainability of growth without economic policy stimulus is a source of uncertainty.

Assessments of sovereign risk issues associated with Greece fluctuated sharply over the past month but on the whole risks remained during the entire period and even intensified towards the end of the month. Although CDS premia in the Western and Eastern regions of Europe moved in the same direction with Greek CDS premia, and the sharp fluctuations in the euro exchange rate were driven mainly by the problems of Greece, the degree of contagion continued to be moderate. As an effect of the significant increase in Greek risk premia in the final days of the period, risk indicators rose all over Europe; the extent of the rise, however, was minor – even in the Balkans and the Mediterranean – compared with the rise in Greek premia. The larger-than-expected credit line established jointly by euro area Member States and the IMF and its much lower funding costs compared with current Greek yields eased market anxiety. Nevertheless, implementation risks may add to market concerns. The support package has not yet been finalised, and timely credit disbursement may be jeopardised by the time required for negotiations with the IMF and necessary parliamentary approval in several countries. In terms of the solvency of Greece, risks have risen materially, as reflected by the credit downgrades by the rating agencies Moody's and Fitch. The emergence of problems in the Greek banking sector, which pose risks for Balkan countries in particular, was another negative development.

Perceptions of risks associated with the Hungarian economy improved during the month. The five-year forward premium five years ahead fell by nearly 40 basis points to 191 basis points. Although the five-year CDS premium was less volatile in the period, its movements reflected the relative improvement in assessments of risks related to the economy. The forint exchange rate stabilised at stronger levels between EUR/HUF 262–268 compared with previous months, associated with continued low volatility. However, there was an increase in the negative skewness in the distribution of exchange rate expectations, and the median of economists' expectations in the Reuters survey showed a 1%–2% depreciation for the coming months.

Yields continued to fall sharply at both short and long maturities in the government securities market. Short-term yields have fallen by 24–35 basis points and long-term yields by 32–54 basis points since the March interest rate decision. The decline in yields was due in part to the liquidity premium falling in response to a mild improvement in perceptions of risks associated with the economy and in part to negative net issuance as well as better liquidity conditions in the government securities market.

The market's interest rate expectations did not decline materially in the month. Based on the survey conducted by Reuters and on market rates, short-term interest rate expectations are for a further reduction in official interest rates. In addition, both the interbank yield curve and analysts' expectations reflect a significant, 25–35 basis point reduction in longer-term interest rate expectations. The bottom of the interbank interest rate curve expected by the market has shifted down by 50 basis points to below 5%, with the majority of analysts expecting the low point of the easing cycle to be either at 4.75% or 5%.

The position of the banking sector

Although outstanding bank lending to the corporate sector fell less sharply in 2010 Q1 than in the previous quarter, the extent of the decline was greater than the forecast in the February *Report*. Whereas in the first two months of the year the stock of loans stagnated, it started falling again in March and, according to preliminary data, continued to fall in April. Within aggregate household debt, the decline in lending by financial corporations picked up particularly sharply. The percentage share of forint loans continued to rise, exceeding 50% of new lending to the sector. The increase resulted from stagnating foreign currency lending and rising forint lending. Within forint loans, mortgage lending and other lending both rose.

Banks' interest margins widened further in March, suggesting that banks maintained interest rates on loans to existing customers with primarily foreign currency debt at a high level, despite the decline in foreign funding costs. While the interest margin contributes significantly to banks' profits, it also reduces household disposable income, thereby restraining the sector's consumption and, ultimately, its savings.

Banks' loss given default (loss provisions over the past 12 months as a percentage of the total outstanding of loans) fell further in March, with the indicator declining from 2.5% to 2.2% for both the corporate sector and households compared with the end of 2009. This implies that the quality of banks' portfolios may have reached a turning point in 2010 Q1. Looking forward, high interest margins and falling credit losses are improving the banking sector's earnings potential and capital adequacy.

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

Monetary Council members agreed that the reduction in perceptions of risk continued throughout April, which made it possible for the Council to continue the easing cycle justified by macroeconomic fundamentals.

In the Council's judgement, data released since the previous interest rate decision had not materially altered the outlook for inflation. The outturn for inflation in March did not come as a surprise. Although in the past the Council had received generally positive information on the prospects for economic activity, members continued to think that, in terms of the broad picture, growth was only expected to pick up significantly in 2011.

Several members agreed that the improvement in the global growth outlook pointed to a possible increase in the risk of imported inflation through a faster-than-expected rise in oil and commodity prices. In assessing the real economic situation, one member noted the risk that demand-side inflation pressure might emerge as growth gathered pace. On another argument, meeting the country's commitments towards international institutions might require further adjustment by fiscal policy, which could restrain demand and reduce the inflation risks associated with the recovery in growth.

The majority of Council members agreed that the projection in the May *Quarterly Report on Inflation* might provide guidance with regard to the longer-term strategy of monetary policy.

Members also agreed that price information from the market clearly suggested an improvement in perceptions of risk. In parallel with movements in the global financial market environment, the Hungarian CDS premium had fallen, government security yields had declined and exchange rates had appreciated recently. It was a particularly positive development for Council members that yields had also declined at the longer end, Hungary's relative risk assessment had improved and that the increasing contagion effect caused by uncertainties surrounding Greece had been limited. However, there was a division of views in the Council in respect of the likely factors behind the improvement in risk perception and how long that improvement could last.

Several members also noted that the latest news on Greece represented high risks in terms of the durability of the improvement in investors' perceptions of risk. For the time being, the market was unsure about whether the Greek government would be capable of implementing a fiscal policy necessary to put public sector finances on a sustainable path. Furthermore, in respect of the international financial support package, the euro area might have difficulty finding a new institutional solution which had never been applied in the past. Some members cautioned that, if the contagion effects spread to other Mediterranean countries, it could cause an increase in perceptions of risks associated with Central and Eastern Europe, including Hungary.

Council 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 April. Some members thought that faster reductions in interest rates than in previous months deserved consideration, as the significant improvement in risk perceptions had provided greater room for policy manoeuvre and the Council should exploit this opportunity as long as major central banks continued to pursue loose monetary policies. Several members, however, argued that reducing interest rates in a sequence of small steps might better facilitate achievement of the Bank's long-term monetary policy objectives. On another argument, despite the improvement external and internal balance the Hungarian economy continued to be vulnerable because of its high debt, which called for maintaining a cautious approach to policy, despite more positive investor sentiment.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Five members voted to reduce the base rate by 25 basis points and two 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 5.25%	**5**	Péter Bihari, Csaba Csáki, Ferenc Karvalits, Júlia Király, András Simor
In favour of reducing the base rate to 5.00%	**2**	Tamás Bánfi, 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

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 31 May 2010. The minutes of that meeting will be published at 2 p.m. on 9 June 2010.