MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 31 MAY 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

In April 2010, annual CPI inflation was 5.7% and core inflation was 4.3%, down 0.2 percentage points and 0.4 percentage points, respectively, on the previous month. Services inflation continued to fall, due to the disinflationary effects of weak domestic demand, and tradables inflation was very low, close to zero. The monthly outturns for tradables inflation may have been driven by the stronger forint against the euro relative to the previous year, in addition to sluggish demand. Consistent with these developments, the trend rate of inflation, which better captures underlying inflation developments, has fluctuated in a range of 1%–2% recently.

In the latest *Quarterly Report on Inflation* projection, in contrast to the previous projection, CPI inflation is unlikely to fall below the target, but rather settle around the target, on the horizon relevant for monetary policy. By contrast, core inflation may fall to a historically low level next year, due to the downward effect on prices from weak domestic demand. The gap between the two measures of inflation may narrow around the target in 2012.

Near-term real economic performance was stronger than expected, but the medium-term outlook did not change materially. According to the preliminary release, Hungary's GDP grew by 0.2% in 2010 Q1 relative to the same period of the previous year and by 0.9% relative to the final quarter of 2009. This growth rate was high compared with the performance of countries across the EU. In addition to the surprisingly strong Q1 data, the CSO also revised Hungary's short-run growth rates upwards for the previous two quarters. Based on the resulting picture, the annual index is now also showing growth. It remains to be seen, however, whether these developments will prove to be only temporary or reflect a more robust upward trend.

Industrial production and exports both fell slightly in March 2010 relative to the previous month, but continued to grow materially in the first three months of the year compared with earlier quarters. Trade in goods continued to show a significant surplus in March. Imports grew more strongly than exports, most likely due to stockbuilding by firms.

In the *Report* projection, the Hungarian economy picks up gradually, owing to the strength of economic activity abroad, with domestic demand factors making an increasingly strong contribution to growth from 2011.

After falling steadily for nearly two years, gross average earnings in the private sector grew above expectations in March. Earnings growth picked up particularly sharply in manufacturing. This may have been explained in part by higher utilisation of existing capacities (i.e. an increase in the number of hours worked) and in part by workers moving back from part-time to full-time jobs. In market services, the growth rate of regular pay did not change materially from the historically low levels seen in earlier months, but bonus payments were slightly higher than expected. On aggregate, the difference between wage developments in the two sectors continued to widen.

Despite the strong earnings growth, retail sales – which traditionally move in close alignment with household consumption – failed to rise by a similar magnitude. Compared to the same period a year earlier, narrowly defined retail sales fell by 4% in March 2010, while total sales, which are more closely aligned with consumption, were down 8.3%. This may be explained by developments in household disposable income: changes to the personal income tax regime bolstered disposable income, while changes to the taxation of non-wage benefits reduced it. At the same time, net borrowing by households was negative again in March. It should be noted, however, that household confidence indicators shifted in a positive direction, perhaps foreshadowing higher future retail sales volumes. Nevertheless, the trend indicators suggest that the pick-up in retail sales may be protracted.

Financial market developments

In April–May, the problems in Greece and other Mediterranean Member States posed a significant challenge to the euro area as a whole. In response, senior EU officials announced extraordinary measures on 8–9 May. For the time being, however, investors seem to have been little affected by the announced rescue plan, with international markets clearly characterised by mounting risk aversion in recent weeks. In addition to global factors, and the general rise in sovereign risk premia in particular, investors' more rigorous assessment of fiscal developments had the greatest impact on developments in the domestic financial market in the past month.

There was an increase in perceptions of the risks associated with the Hungarian economy in the past month. Although risk premia rose across the board in developed as well as in emerging markets in the wake of the deterioration in investor sentiment, and movements in Hungarian risk premia did not diverge materially from developments in Central and Eastern Europe, there was a relative deterioration in Hungary's position as reflected by certain measures of risk. For example, the Hungarian five-year CDS premium rose from 185 basis points to 241 basis points. This increase in the premium was significant in a regional comparison: CDS premia in Romania, Bulgaria and Croatia, which are generally perceived to have broadly similar risk profiles as Hungary, and the CEEMEA composite index rose by only 20–25 basis points. Only in Ukraine did the premium rise more sharply than in Hungary. The deterioration in risk assessments was even more clearly evident in the five-year ahead five-year forward premium, which surged from 195 basis points to 290 basis points in one month. By contrast, it remained practically flat in the Czech Republic and rose by 35 basis points in Poland. The spread on Hungarian five-year foreign currency bonds over German bonds of comparable maturity rose by nearly 130 basis points, due to an increase in Hungarian yields and a fall in German yields, while in the Czech Republic and Poland the spread increase on euro-denominated bonds broadly mirrored the decline in German bond yields.

Negative sentiment on the international markets was also reflected in a depreciation of the forint. From about EUR/HUF 265 at the end of April, the exchange rate weakened in waves, falling to levels as low as EUR/HUF 283–284 on several occasions. The forint reversed part of its losses by the end of the period, strengthening to levels close to EUR/HUF 275. In a regional comparison, movements in the forint were broadly aligned with those in the zloty, but the Hungarian currency clearly underperformed the Czech koruna and the Romanian leu. Implied volatilities and risk reversal quotes for the forint both jumped higher, indicating significant uncertainty in expectations for the value of the forint and their marked downward skew. The Reuters poll, conducted in early May, did not yet reflect these tendencies: the consensus forecasts for the exchange rate for horizons from 1 out to 12 months were spread within a relatively narrow range, their values changing little compared with the previous forecast.

There were significant changes in non-residents' forint position and their forint asset holdings. Non-residents have sold large amounts of forint assets since the last interest rate decision, reducing their holdings of government bonds, MNB bills and quoted shares by a total of HUF 320 billion. In addition, they sharply increased their short forint positions, with their net outstanding FX swap positions rising by around HUF 515 billion. In parallel, changes in liquidity indices in each financial market segment indicated a decline in liquidity to varying extents.

Yields in the government securities market rose markedly, affecting virtually each maturity along the curve. But yields rose most sharply at longer maturities: at 3–5 years, benchmark yields jumped by 90–115 basis points to nearly 6.3%–6.9%, and 10–15 year yields, at 7.3%, were some 85 basis points higher than in the previous month. At the short end of the forward curve, i.e. up to one year, rates shifted upwards by 10–60 basis points and by 60–160 basis points at the longer end, i.e. beyond one year. The strongest increase occurred in the middle of the curve.

The market's interest rate expectations declined markedly in May, except for some correction towards the end of the month. Forward rate agreements for maturities of up to a couple of months reflected an increasing likelihood that official interest rate would be lowered by 25 basis points. Yield curves in both the interbank and government securities markets shifted upwards. Their shape suggests that the current easing cycle may reach its low point at around 5% in the autumn of 2010. Expectations that the Bank might take a more cautious approach to setting interest rates also began to appear in investors' analyses, in addition to market prices. Moreover, based on the survey conducted by Reuters, expectations of the majority of analysts suggested a similar picture to the yield curve.

Position of the banking sector

After the decline in March 2010, outstanding bank lending to the corporate sector fell significantly again in April, by more than HUF 100 billion. On aggregate, total corporate lending by banks and their branches fell by HUF 226 billion or 3.3% in the first four months of the year. The decline in outstanding household loans accelerated in the first four months. With the HUF 20 billion fall in April, the decline in total outstanding bank lending for this year amounted to HUF 70 billion or nearly 1%.

The quality of bank loans to both the corporate and household sectors deteriorated further in 2010 Q1. The ratio of loans in arrears of more than 90 days increased broadly at the same rate as in previous periods, reaching 11.5% and 8.6% for companies and households, respectively. By contrast, the value of loan losses as a percentage of the total fell slightly. Consequently, the downward effect on bank earnings of loan loss provisions (2.4% for both companies and households) was less than expected. Based on cumulative within-year data, the banking sector's earnings rose significantly. Pre-tax profits amounted to HUF 203 billion in the first four months of 2010, up from HUF 151 billion in the same period of 2009. Return on equity, calculated from pre-tax profits for the previous 12 months, rose from 13.6% to 14.7%, with return on assets edging up from 1% to 1.2%. The decline in provisioning and high interest income were the two major contributing factors of the increase in earnings. Banks' capital positions continues to be satisfactory: the sector's capital adequacy ratio stood at 12.9% at the end of March 2010.

From the perspective of the monetary transmission mechanism, it was a positive development that forint loans continued to rise as a percentage of new lending to the household sector: forint-denominated loans accounted for 76% of new loans in April. Another positive aspect is that the importance of forint loans has been rising within mortgage lending. The new regulation on prudent lending has not yet had a major impact on lending volumes, but may have contributed to the shift towards forint loans within the total.

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

Monetary Council members agreed that there had been a deterioration in the outlook for inflation and perceptions of risks associated with the economy compared with the positive developments in the previous period, reducing the scope for easing monetary policy.

In the Council's judgement, the projection in the May 2010 *Quarterly Report on Inflation* indicated a stronger outlook for short-term growth and a higher profile for inflation over the entire forecast horizon relative to the previous projection. To a great degree, the upward revision to the forecast stemmed from changes in assumptions about exogenous factors, i.e. a higher oil price and a weaker euro exchange rate against the US dollar. Nevertheless, domestic developments also pointed to a higher inflation path. Owing to the faster-than-expected global recovery, domestic industrial production might be higher and the pick-up in consumption faster than previously assumed. As a result, the output gap might close somewhat faster than expected, and thus its disinflationary effect would weaken earlier.

There were diverging views in the Council regarding the risks to the outlook for inflation. Several members felt that a weaker forint exchange rate than assumed in the current projection, upside risks to the price of crude oil and the potential convergence of service sector earnings with manufacturing earnings growth posed significant upside risks on the horizon relevant for monetary policy. Others noted that fundamentals were changing in a positive direction: core inflation stood at a historically low level, service sector earnings were growing at a modest pace, and the revaluation of household foreign currency debt through the wealth effect suggested that domestic demand would remain subdued even over the longer term. Other members pointed out that past movements in the exchange rate and oil prices had been particularly volatile, and that therefore the uncertainty surrounding the assumptions underlying the projection was greater than usual. Consequently, the risks were not clearly on the upside.

Several members noted that anchoring inflation expectations, i.e. keeping inflationary pressures from taking hold with the economic recovery, was becoming a key issue as demand picked up. Some members were of the view that available information did not suggest that expectations were stuck at an elevated level. On another argument, the Government's economic policy also played a crucial role in anchoring inflation expectations. For the time being, however, little was known about the details of the Government's planned measures. Consequently, the Council would only consider them in its future policy decisions.

There was agreement among Council members that there had been a clear deterioration in assessments of the risks associated with the Hungarian economy following escalation of the Greek financial crisis and that uncertainty in the international environment had increased notably. In addition to the deterioration in the external environment, uncertainty about the prospects for the domestic economy had not lessened either.

The majority of Council members agreed that a general decline in risk tolerance, coupled with a sharper increase in long-term yields and the CDS premium compared with the CEE region, implied a deterioration in Hungary's relative position. Several members thought that this may have been related to uncertainty surrounding domestic economic policy and market participants' more pessimistic expectations about Hungarian fiscal policy compared with the past. One member emphasised the sensitivity of the Hungarian economy to market contagion. Some members noted that it might take some time before the European sovereign crisis was resolved, and, therefore, uncertainty in the external environment might remain for longer. Other members, however, commented that a reduction in global uncertainty could not be ruled out looking forward, which, if it was reflected in domestic perceptions of risk, could provide an opportunity to reduce interest rates further.

It was also argued that, compared with other countries of Europe, Hungary would be in a better position after fiscal adjustment took place and risk perceptions could confirm this, provided that fiscal disciple remained. One member noted that market developments were shaped primarily by international events, and, therefore, a further interest rate reduction would not have a material impact on Hungarian asset prices either.

The vast majority of Council members were of the view that in the current situation neither the requirements of inflation targeting nor assessments of risks facing the economy allowed for a reduction in interest rates. Interest rates might only be reduced further if the outlook for inflation and perceptions of risks improved.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Five members voted to maintain the base rate at 5.25% and two members voted for a reduction of 25 basis points.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 5.25%	**5**	Péter Bihari, Ferenc Karvalits, Júlia Király, Judit Neményi, András Simor
In favour of reducing the base rate to 5.00%	**2**	Tamás Bánfi, Csaba Csáki

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

Katalin Haraszti, Head of Department of the Ministry for National Development and Economy, was present as the Government's representative.

The Council will hold its next policy meeting on 21 June 2010. The minutes of that meeting will be published at 2 p.m. on 7 July 2010.