MAGYAR NEMZETI BANK

MINUTES
OF THE MONETARY COUNCIL MEETING
OF 29 NOVEMBER 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/Monetaris_politika/decision-making/mnben_mt_jegyzokonyv

1 Macroeconomic and financial market developments

The domestic economy

In October 2010, annual CPI inflation was 4.2% higher than the year before, and core inflation was 1.8% for the same period. Rising food prices are behind these unfavourable inflation developments. The weakening of the exchange rate in early summer has still had no tangible impact on the prices of industrial goods, and – in light of the fact that the exchange rate has strengthened somewhat since then – it is now less likely to occur. Services inflation remained historically low, supported by subdued earnings growth in the sector. Higher prices of unprocessed foods impacted prices of processed foods to a significantly higher degree than projected in the August *Quarterly Report on Inflation*. Household inflation expectations remained well above the Bank's inflation target.

Labour market conditions remained loose. The sharp increase in private sector earnings in August adjusted in September, and returned to the moderate annual growth rate of 4% seen previously. The increase in the number of employees in recent months is primarily attributable to manufacturing industries. As this sector accumulated significant labour force reserves during the crisis, growth in employment remained subdued in spite of increasing industrial activity. Unemployment is dropping slowly due to the slight increase in the number of people in employment and the rise in labour market activity, with the rate at 11% in the third quarter.

According to preliminary data, Hungary's GDP increased by 1.6% in Q3 relative to the same period of the previous year. The volume of industrial production and retail sales indicates that the export sector is likely to remain the driving force behind growth, while domestic demand is expected to play a diminishing role in restraining growth.

During the third quarter industrial production increased by 3%. Based on the confidence indices in Hungary's major export markets, favourable external market conditions are expected to prevail for the remainder of the year. The fact that the domestic sales of industrial companies have also started to climb in recent quarters may suggest a turnaround in domestic demand. The trade account of goods and services remained at the high level seen in recent months.

In recent months, retail trade figures have turned out better than the path projected in the August *Quarterly Report on Inflation*. Based on trend developments, it is likely that the turnaround in consumption which was originally expected for this year may have occurred in the third quarter. As the consumption rate is on the rise, with marginally higher net wages, the prolonged improvement in household expectations is likely to continue. At the same time, the rate of borrowing in the sector remained significantly lower than the rate seen before the crisis.

The decline in the real estate market continued during the third quarter as well. The number of occupancy permits and building permits issued dropped by 35% and 27%, respectively, relative to the same period of the previous year. Developments in the real estate market usually follow changes in the macroeconomic environment with some delay, and therefore a turnaround in the real estate sector is not expected at this time. The volume of new housing loans still does not point to any growth in the real estate market.

Financial market developments

In the first half of the period since the last interest rate decision in October, international investor sentiment was essentially influenced by heightened expectations that the Fed would continue to ease monetary policy and its announcement thereof, followed in the second half by news on the financial situation in Ireland. Due to the former developments, international markets turned optimistic, equity indices and commodity prices rose significantly, demand for risky financial assets increased, and the US dollar weakened considerably. However, the upswing in sentiment turned out to be fleeting on account of developments in Ireland, and considerable adjustments took place during the latter part of the period: developed and emerging equity markets experienced significant declines, and the euro dropped from above 1.40 to 1.32. The markets failed to respond positively to the announcement of an EU/IMF emergency rescue package for Ireland, hence risk aversion remained a factor toward the end of the period as well. The increase in CDS spreads had the greatest impact on peripheral member states, whereas at the same time the developing region of Central and Eastern Europe appeared relatively more resilient than in the past.

During the last month, perceptions of risks associated with the Hungarian economy declined, although to different degrees in various markets: the relative stability of the exchange rate and the purchases of financial instruments denominated in forints by foreign investors were offset by the considerable rise in risk indicators and long-term forint yields. The five-year Hungarian sovereign CDS spread increased by close to 50 basis points since the last rate-setting meeting; apart from the peripheral euro area states, this is considered remarkable in international comparison, in other words, Hungary’s relative position has deteriorated significantly as well. The spread of the five-year forward rate five years ahead over the euro rose by close to 30 basis points, while the spread in Poland stagnated; and the spread of the five-year Hungarian euro bond also rose by almost 20 basis points relative to German bonds, which was also evidence of relative deterioration compared to the region.

The forint exchange rate, on the other hand, moved within a relatively narrow range between EUR/HUF 270 and 278 practically for the entire period, showing a significant drop towards the very end, as the rate rose to around 280. As far as the region is concerned, the forint overperformed in the first half of the period, and underperformed in the second half, showing some signs of deterioration in the country’s relative position as well. Moreover, implied volatilities and risk reversal quotes indicate that no major changes have taken place in long-term exchange rate expectations so far.

Non-residents’ total forint position increased further as a whole, with purchases amounting to more than HUF 50 billion in the spot foreign exchange market last month. Similarly, non-residents increased the value of their holdings of forint-denominated government paper by HUF 140 billion, more or less equally distributed among different maturities. At the same time, even though the volume of MNB bonds held by non-residents surged – temporarily – to historical highs during the period, a decline of HUF 100 billion was seen in this particular instrument for the period as a whole. Moreover, a speculative position was taken in respect of the forint, as non-residents' synthetic forward positions taken simultaneously with spot and FX swap transactions increased by about HUF 35 billion.

The increase in non-residents' holdings of forint-denominated government securities occurred in conjunction with a sharp rise in market yields. The yield of long-term reference government securities rose by close to 80 basis points since the last interest rate decision, on account of which all long-term benchmark yields were well over 7%, with 10–15 year yields at around 7.8%. At the same time, the level of yields at the long end of the government securities forward yield curve rose to above 7%.

Auctions of government debt brought mixed results: while discount Treasury bills are still in high demand and – primarily in the case of 3-month discount Treasury bills – yields at the auctions were relatively stable, the bond auctions were clearly and significantly marked by increases in average yields, and the degree of oversubscription showed considerable fluctuations.

Money market yields point toward a relatively steady rise in expectations of an official interest rate increase. FRA quotes rose by 15–40 basis points – depending on the maturity remaining until start – on account of which a full increase of 25 basis points had been priced on the 1x4 month maturity period before the interest rate decision. Rates for forward rate agreements for the periods beginning in one, two and three months' time are consistent with an interest rate level that is 26 basis points, 34 basis points and 46 basis points higher, respectively, than the central bank base rate from before the interest rate decision. Consequently, the short end of the money market yield curve has become steeper in recent months, implying a 6.5% base rate by the end of next year.

Investment banks have yet to voice any concerns about the possibility of stricter monetary policies in the near future, as analysts did not anticipate the central bank to announce the first interest rate hike until the first quarter of next year.

Respondents to the Reuters poll conducted in November are unanimous in expecting official interest rates to remain on hold at the Monetary Council's meeting on Monday, with only one analyst forecasting an increase of 25 basis points. Of the analysts surveyed, only two expected interest rates to be changed this year, while the majority were of the opinion that interest rates are more likely to remain on hold next year, as opposed to any increase. The survey did not provide solid grounds for making any robust statement as to expectations relating to the beginning of any interest rate hike, as the number of respondents answering this particular question was considerably less than previously, and the distribution of the answers was relatively wide as well.

Position of the banking sector

Outstanding lending to companies fell sharply in 2010 H1, but the pace of decline slowed in the third quarter. In October, the volume of outflow was relatively moderate at HUF 8 billion at the level of the whole banking system. However, it is still too early to postulate a turnaround in lending to the corporate sector, although in all likelihood it is close to bottoming out. Nevertheless, the Hungarian financial system continues to provide very limited support to the economic recovery. As far as mortgage loans are concerned, there are no signs of a turnaround, with the rate of decline remaining high in October, showing minus HUF 27 billion in loans.

In 2011, corporate borrowing may begin to recover first, followed by an upturn in lending to households. However, there is a high risk that the turning point will occur later than anticipated. In the corporate sector, the fragility of activity abroad and, in the household sector, the protracted adjustment process due to the large amount of outstanding debt and high debt servicing costs may pose a risk to the recovery of demand for credit. On the supply side, risks may also arise due on the one hand to uncertainty caused by the special levy on banks and on the other hand to a deterioration in loan quality, due to the strength of the Swiss franc and the resulting credit losses that may have a negative impact on demand.

The liquidity position of Hungarian banks is judged to be strong and the share of liquid assets adequate. As far as the assessment of liquidity risks is concerned, the volume of foreign liabilities and outstanding swaps of banks remain a major factor. According to preliminary data, the volume of banks' foreign liabilities increased further in October. This, however, is attributed to one bank only, whereas the other institutions continued to show signs of further decrease. The ratio of liabilities with a maturity of less than one year increased which, on the other hand, is likely to lead to an increase in rollover risks. The volume of swaps did not increase further, and the declining trend seen previously appears to have stopped.

Non-performing corporate and household loans rose to above 12.5% and to 10.6%, respectively, of the total outstanding amount by the end of September 2010. At the same time, the cost of provisioning as a share of the total amount of outstanding loans remained at the high level of June, 3% for both corporations and households in September. Based on the data available, the forecast for October indicates no change. Rising loan losses in the corporate sector are explained by the weak performance of project financing and, in the household sector, by the pass-through of the strong Swiss franc and persistently high unemployment, and high external funding costs into high debt servicing burdens.

The speed at which banks are restructuring their portfolios, which is currently considered very low, may greatly influence developments in the ratio of non-performing loans. If the pace of portfolio restructuring remains unaltered, the ratio of non-performing loans may reach its peak later than expected, and may slightly exceed 15% next year for both companies and households. Provisions as a percentage of total outstanding loans may peak at around 3% this year, instead of last year, and decline gradually next year as the economy recovers, due in part to lower loan losses and in part to stronger credit growth.

The profitability of domestic banks continued to decline. By the end of October, the 12-month rollover ROE of banks was below 5%. Pre-tax profit for the first 10 months failed to reach HUF 100 billion (compared to HUF 286 billion in the same period of the previous year). Taking into account that the month of December is traditionally slow, and that the second instalment of the bank levy – approximately HUF 60 billion – is due in December, the profitability of the banking sector at the end of 2010 will be very low. According to the November issue of the *Report on Financial Stability*, the ROE of banks is expected to be around 2.5%.

Banks' adequate capital position ensures that the financial system is still able to absorb shocks (the sector's capital adequacy ratio stood at 13.2% at the end of September). In the baseline scenario of the stress test, there is only a minimal need for capital injection. Although the sector's capital adequacy ratio is expected to drop according to our baseline projection, it shall remain above 12% nevertheless (taking into account the impact of capital increases already declared for this year), and is projected to rise slightly by the end of 2011, without paying any dividends. In the stress scenario, the aggregate capital adequacy ratio would be falling in both 2010 and 2011, but its value would still remain around 11%. In the stress scenario, a manageable additional need for a capital injection on the order of HUF 40 billion would arise, which is judged to pose little risk, both in terms of its amount and the commitment of parent banks to their subsidiaries.

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

After discussing the recent macroeconomic information, the Bank's November *Quarterly Report on Inflation* and financial market developments, the Council considered proposals to maintain the base rate or raise it by 25 basis points. There was unanimous agreement that the November inflation projection should be the starting point for the decision on interest rates this month. The baseline projection for inflation was above the target over the period to 2012, assuming unchanged monetary conditions.

A vast majority of Council members felt that the outlook for inflation in Hungary had deteriorated markedly in the period since publication of the August *Report*. It was noted that the disinflation process had come to an end, despite moderate wage growth, with the sharp increase in food prices playing a key role. Another adverse development was that inflation expectations seemed to have been stuck in the 4%–5% range recently. Several members noted that other factors might also add to inflationary pressure in 2011 and 2012, in addition to the second-round effects of the food price shock and the probability that inflation expectations would exceed the Bank's medium-term target. Firms might pass on a large part of the cost of the extra taxes, especially if they were imposed over a longer period. In addition, the negative output gap closing earlier than previously expected might also imply higher future inflation. In 2011, however, the effects of these factors might be temporarily offset by the maintenance of the gas price subsidy scheme.

Council members agreed that over the short term the economy might grow more rapidly than previously thought, due to the greater-than-expected reduction in taxes, faster growth in Hungary's export markets and a number of large individual investment projects currently underway. At the same time, however, several members thought that the use of unconventional economic policy tools might reduce potential output through increases in risk premia and the cost of capital. All this might be reflected in a faster-than-expected closing of the output gap and, therefore, the negative output gap might have a smaller disinflationary impact than previously assumed.

In addition to the trends in inflation, the Monetary Council also reviewed latest developments in perceptions of the risks associated with the Hungarian economy. While the risk premium had fallen temporarily after the Government committed itself to meeting the 3% deficit target, there was a significant deterioration in sentiment after the announcement of the details of the Government's fiscal action plan, which was reflected in a rise in Hungary's CDS premium. Measures undermining the predictability of the economic environment, for example, the imposition of retroactive taxes and the decisions affecting the private pension fund system, played a key role in the sharp increase in perceptions of the risks associated with the economy.

Several members took the view that the alternative path, according to which perceptions of the risks associated with the economy would increase further, had a greater probability of materialising than the baseline scenario outlined in the *Report*. In this scenario, the increase in perceptions of risks was closely related to fiscal sustainability risks and in part to the associated increase in financing costs, which, in turn, might be aggravated by less robust global activity than assumed in the baseline projection. A further increase in perceptions of risks might lead to sustained exchange rate depreciation and, indirectly, in the absence of appropriate monetary policy response, to higher inflation. It was also argued that the scenario in which inflation expectations became stuck above the medium-term target, in addition to an increase in perceptions of risks, was the most probable.

The majority of members thought that either the deterioration in the inflation outlook or the sustained, significant rise in the risk premium alone was sufficient to warrant an increase in interest rates, as the Council's previous press releases had noted. Several members argued that an increase in interest rates this month could signal the Council's commitment to meeting the inflation target, but that achieving that goal may also require further interest rate increases in the coming months. On another argument, the interest rate increase might entail output sacrifice, although this was seen as relatively small in view of the foreign currency debts that had accumulated in private sector balance sheets.

Several members had thought that – due to the output gap having a strong disinflationary impact and closing only slowly – the target could be met in previous months without having to increase interest rates. However, due to the changes in the assessment of economic developments, this disinflationary impact alone would not be sufficient. One member had previously thought that Hungary would probably implement a sustainable economic policy mix, which would encourage higher capital inflows and contribute to a decline in the risk premium. That could have ensured that the monetary conditions required to meet the inflation target were in place without an interest rate increase. However, this member now saw the chances of that happening as very remote. On another argument, however, it was possible that the Government would implement structural measures which might contribute to an improvement in perceptions of the risks associated with the economy.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Six members voted to raise the base rate by 25 basis points and one member voted to maintain it at 5.25%.

Votes cast by individual members of the Council

In favour of raising the base rate to 5.50%	**6**	Péter Bihari, Csaba Csáki, Ferenc Karvalits, Júlia Király, Judit Neményi, András Simor
In favour of maintaining the base rate at 5.25%	**1**	Tamás Bánfi

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

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

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

The Council will hold its next policy meeting on 20 December 2010. The minutes of that meeting will be published at 2 p.m. on 12 January 2011.