MINUTES
OF THE MONETARY COUNCIL MEETING
20 DECEMBER 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 November 2010, annual CPI inflation was 4.2% and core inflation was 1.8%. The results confirm other evidence that inflation started to rise from the middle of the year, as measures of underlying inflation increased to almost 3% over the past few months. Industrial goods and services inflation remained subdued in November, with low earnings growth in services being a contributing factor, in addition to weak demand. Prices of processed and unprocessed foods continued to rise in November, but the pace of this increase was slower than expected. The outlook for inflation deteriorated in the wake of the increase in petrol prices, announced after publication of the *Quarterly Report on Inflation*. On balance, therefore, inflation at the end of 2010 seems likely to be broadly as projected in the *Report*.

According to the detailed CSO release, Hungary's gross domestic product grew by 1.7% in 2010 Q3 relative to the same period of the previous year. In seasonally adjusted terms, GDP grew by 0.8% on the previous quarter. Rising economic activity abroad continues to be the driving force behind Hungarian growth, but recent evidence suggests that a recovery in domestic demand occurred in Q3. Accordingly, while robust industrial production growth continued to be the source of domestic growth, value added in market services was also higher than its level a year earlier.

The recent pick-up in domestic demand masks divergent trends. Household consumption rose once again after falling in the previous seven quarters, and there was a large build-up of stocks among companies. At the same time, corporate investment continues to be subdued, adversely affecting the prospects for long-term growth. The decline in investment activity may have been closely related to lower government investment in infrastructure and lagging residential construction. That was only partially offset by an increase in the capital stock in manufacturing.

Preliminary foreign trade data suggest further growth in goods trade in October, in line with the trends of earlier months and, consequently, Hungary's goods surplus remained broadly unchanged. In October, seasonally adjusted industrial production was down 1% on the previous month. Most of the slowdown in production growth may have been accounted for by the renewed decline in domestic sales, which ran contrary to the Bank's projection of a gradual recovery in domestic demand. By contrast, the rate of export growth continued to be robust. However, the high levels of confidence indices suggest that industrial production growth is likely to pick up further steadily, and there is little reason to expect a decline.

Private sector earnings grew by 3% in October relative to the same period a year earlier. Moderate earnings growth continued in both manufacturing and market services. Regular pay growth remained historically low, explained by the strong downward pressure on wages from the loose labour market. Labour Force Survey data for Q3 suggest that employment growth is faltering. Given that the activity rate has changed little recently, the unemployment rate remains at a historically high level of around 11%.

Financial market developments

Sentiment in international financial markets has been positive in the period since the Council's November interest rate decision. Risky asset prices rose, as did yields in the USA and Germany. The markets' optimism was reflected in rises in major commodity prices and in falls in the various measures of risk. The VIX index dropped to levels not seen since April, and a number of developed market equity indices advanced close to yearly highs. In foreign exchange markets, the dollar depreciated against the major currencies, while emerging market currencies appreciated.

The backdrop to these positive developments included the agreement by EU finance ministers on the details of a financial rescue package for Ireland and the release of better-than-expected macroeconomic data in the US. In addition, central bank communication related to further quantitative easing measures and changes materially influencing economic growth overseas affected movements in asset prices.

Investor sentiment towards Hungary continues to be mixed. Foreigners' demand for forint assets increased, but the various indicators paint a gloomy picture of perceptions of the risks associated with the economy, with Moody's downgrade of Hungarian sovereign debt by two notches probably being a contributing factor, in addition to uncertainty surrounding the Government's economic policy measures. Hungary's five-year sovereign CDS premium rose from around 330 basis points at the end of November to close to 380 basis points. At the same time, the composite index of Central and Eastern European countries remained broadly unchanged, clearly indicating a deterioration in Hungary's relative position in recent weeks. The spread on five-year Hungarian euro-denominated bonds over German bonds rose by some 30 basis points, which also represents a deterioration relative to other countries of the region. But the spread of the five-year ahead five-year forward rate over the euro fell by some 30 basis points to a level broadly the same as the Polish spread over comparable maturity, which slightly altered that picture.

Over the past three weeks the forint appreciated by more than 2% against the euro, outperforming several other currencies of the region. Initially, the exchange rate weakened temporarily from EUR/HUF 280, before strengthening gradually to below EUR/HUF 275. Implied exchange rate volatility fell at short maturities as the forint appreciated, but remained largely unchanged at longer maturities. Expectations of exchange rate depreciation have intensified: the skewness of the probability distribution of expected exchange rate depreciation is currently higher than in November. In the FX swap market, implied forint yields did not decline significantly. This suggests that the ability of the Hungarian banking sector to attract foreign currency liquidity has not improved in recent weeks.

Although risk premia and movements in the forint exchange rate help little to gain a clear picture of the motivations behind foreign investors' demand for forint assets, the available data provide evidence of substantial purchases of government paper by the non-resident sector. Non-resident holdings of government bonds have risen by more than HUF 70 billion since the end of November. Within this figure, purchases of three and ten-year bonds amounted to HUF 30 billion

each. At other maturities, holdings of government paper were little changed in net terms. The secondary market accounted for a smaller part of purchases, with bond auctions accounting for the larger part. Holdings of discount Treasury bills fell by more than HUF 60 billion, due mainly to the maturity of two bills in the period. Flows of funds into emerging markets due to the policy of quantitative easing in the USA may play a key role in purchases of government paper by non-residents. Non-residents also bought some HUF 230 billion of MNB bills, in addition to government paper in the month. They financed their asset purchases mainly by buying in the spot market, while they delivered foreign currencies in the FX swap market in net terms. Non-residents' total long forint positions have increased by some HUF 110 billion since the November interest rate decision.

The auctions of government debt in the past weeks were conducted successfully. Primary dealers' demand for five and ten-year bonds was higher than in previous months, although average yields increased. Nevertheless, the Debt Management Agency raised the amount on issue because of oversubscriptions. Turnover increased sharply in the secondary market of government securities, mainly affecting longer-dated paper.

The steepness of the government yield curve fell as global investor sentiment improved and the liquidity premium declined. At the short end of the curve, yields rose in line with the increase in official interest rates. At maturities between 1 and 3 years, yields remained broadly unchanged. Long-term yields fell by 30–35 basis points. The five-year government bond yield currently stands at 7.6% and the ten-year yield at 7.75%.

The November interest rate decision surprised the market and led to an increase in the expected path of interest rates. In aggregate, however, expectations showed a mixed picture. FRA rates, reflecting money market expectations, were in line with an increase of 25 basis points at the Council's December meeting and reflected further gradual increases for the coming months. By contrast, market analysts' expectations were widely spread. According to the latest Reuters poll, about half of respondents expected interest rates to remain on hold in December, with a smaller part of them expecting the tightening cycle to continue. Several respondents did not provide a forecast for January, while several others did not expect an interest rate increase at the next two meetings. But the majority of economists expecting an increase in December also anticipated that rates would be raised in January. Consequently, analysts' consensus forecast is for the base rate to be 5.75% in January.

Position of the banking sector

Outstanding lending to companies continued to fall in November. Total outflows from the banking sector amounted to HUF 27 billion. Unlike earlier, net flows were not only negative for foreign currency loans in November, but also for forint loans. There continues to be little sign yet of a turnaround in corporate lending, although outflows were much smaller in H2 than in H1. Bank lending is unlikely to contribute to growth over the short term. The household credit market shows no signs of a shift in the trend: outstanding loans continued to decline sharply in November 2010, with net flows amounting to HUF -27 billion.

In 2011, corporate borrowing may begin to recover first, followed by an upturn in lending to households. There is, however, a high risk that the turning point will occur later than anticipated, and the November data has added to that risk. 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. Risks may arise on the supply side as well. Uncertainty caused by the special levy on banks, on the one hand, and a deterioration in loan quality, due to the strength of the Swiss franc and the resulting credit losses, on the other, may have a negative impact on demand.

The liquidity position of Hungarian banks is judged to be strong and the ratio 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 key factor. According to preliminary data, banks' foreign liabilities fell sharply in November. There was no further increase in the ratio of liabilities with a maturity of less than one year to total liabilities in the month. The sector's outstanding swaps stopped rising further in November, and the shortening in maturity appears to be drawing to an end. The on-balance sheet foreign currency position of the banking sector widened in early December and the level of swaps outstanding increased. At the same time, the cost of funds rose and swap spreads widened.

Non-performing corporate and household loans rose to above 12% and to 10.6%, respectively, of the total outstanding amount by the end of September 2010. Loan-loss provisions as a share of the total amount of outstanding loans, at 3% for both corporations and households, remained at the high level of June. Rising loan losses in the corporate sector are explained by the weak performance of project financing and, in the household sector, by the strong Swiss franc, persistently high unemployment and the pass-through of the high external funding costs into debt servicing burdens.

In contrast to the Bank's earlier expectations, 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. 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. Provisions as a percentage of total outstanding loans may peak at around 3% this 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 improved slightly in November. Despite this, however, the 12-month rolling ROE of banks was below 5%. Pre-tax profit for the first 11 months amounted to just HUF 130 billion (compared with HUF 336 billion in the same period of the previous year). Taking into account that the results for the final month of December are usually weak, 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 is likely to be very low.

The adequate capital position ensures that the financial system is still able to absorb shocks. The sector's capital adequacy ratio stood at 13.3% at the end of October, reflecting a slight

increase relative to September. In the baseline scenario of the stress test, there is no need for capital injection. Although the sector's capital adequacy ratio declines in the baseline projection, it still remains above 12% (taking account of the impact of capital increases already declared this year) and is projected to rise slightly by the end of 2011, excluding the effect of dividend payments. In the stress scenario, the aggregate capital adequacy ratio would fall in both 2010 and 2011, but its value would still remain around 11%. 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 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 still be used as the starting point for the decision on interest rates this month. The baseline projection for inflation was above the 3% target over the period to 2012, assuming unchanged monetary conditions.

Council members agreed that the outlook for inflation had not changed materially in the period since the November interest rate decision. They viewed the recent slower-than-expected increase in food prices and October's modest wage rise as favourable developments. By contrast, the recommendations for wage increases, agreed at the National Interest Reconciliation Council, and rises in the price of oil were exacerbating the upside risks to inflation. Several members noted that the wage recommendations for 2011 might have the strongest influence on inflation expectations. On another argument, press reports suggesting that the inflation target might be raised could also adversely affect inflation expectations.

One member thought that recent business investment data highlighted the risks to potential output. Rising consumption, in turn, pointed to a faster-than-expected closing of the negative output gap. Both developments had potentially negative implications for inflation expectations, as the output gap might be smaller, which might entail more modest disinflationary effects.

In assessing current economic conditions, the Monetary Council also reviewed recent changes in perceptions of the risks associated with the economy, in addition to developments in inflation. Members agreed that despite the improvement in confidence in emerging markets, perceptions of the risks associated with Hungary had not fallen. It was also argued that the expenditure side reform measures, to be drawn up for 2011 Q1, might contribute to a decline in the risk premium, if they addressed medium-term fiscal risks adequately.

A vast majority of Council members agreed that the need to meet the inflation target and financial stability considerations both called for a tightening of monetary conditions. One member argued that, as a result of the foreign currency debt accumulated in private sector balance sheets, a potential, sustained exchange rate depreciation would increase financial stability risks significantly and, therefore, the real economic costs of disinflation were smaller

than before the crisis. However, views were divided as to the size of the interest rate increase required in order to meet the inflation target and the timing of possible further actions. Members judged that, based on the baseline projection in the *Quarterly Report on Inflation*, the inflation target could be met through a measured tightening of monetary policy. A larger tightening move was favoured by those members who thought the probability of a deterioration in risk perceptions or inflation becoming stuck above the medium-term target was greater than in the baseline projection.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Four members voted to raise the base rate by 25 basis points and one member voted to leave the base rate unchanged.

Votes cast by individual members of the Council

In favour of raising the base rate to 5.75%	**4**	Péter Bihari, Júlia Király, Judit Neményi, András Simor
In favour of maintaining the base rate at 5.50%	**1**	Ferenc Karvalits

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

Péter Bihari
Ferenc Karvalits
Júlia Király
Judit Neményi
András Simor

Dániel Palotai, 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 24 January 2011. The minutes of that meeting will be published at 2 p.m. on 9 February 2011.