MINUTES
OF THE MONETARY COUNCIL MEETING
21 FEBRUARY 2011

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 January 2011 annual CPI inflation stood at 4.0% and core inflation at 1.7%. Inflation on these measures fell by 0.7 of a percentage point and 0.3 of a percentage point respectively relative to the previous month. Modest increases in prices in the core inflation measure and in administered prices also contributed to the decline in CPI and core inflation in the month, in addition to the effects of increases in indirect taxes in the previous year dropping out of the annual comparison. As a result, the measures of underlying inflation fell significantly in January after a period of stagnation in previous months.

Annual services inflation dropped to a historically low level of below 2% in January. Looking forward, this development is particularly important given that a large part of within-year price adjustments takes place in the early months of the year. It is important to note, however, that most of the fall in services inflation was accounted for by lower motor vehicle insurance premia.

The monthly rate of food price inflation continued to fall, implying that the pass-through of cost shocks triggered by the sharp rises in unprocessed food prices has so far been very subdued. Industrial goods prices were practically flat in the month. There continues to be little sign yet that the windfall taxes have generated upward pressure on prices. Increases in administered prices were smaller compared with those usual at this time of the year.

On balance, the January inflation data point to very subdued pricing intentions, despite the cost shocks of recent months. However, there is a risk that, notwithstanding the modest price increases and smaller-than-usual rises in administered prices in January, overall CPI inflation will significantly exceed the MNB's inflation target.

According to the CSO's preliminary release, which does not contain data relating to the components of GDP, Hungary's gross domestic product grew by 2% in 2010 Q4 relative to the same period of the previous year. On a quarter-on-quarter basis, GDP grew by 0.2%. GDP growth amounted to 1.2% in 2010 as a whole.

Domestic economic growth slowed significantly in the final quarter of 2010. That was consistent with developments in most European countries in the period. Exports are likely to have remained the engine of domestic growth. By contrast, growth in sectors producing for the domestic market seems to have been very muted in the final three months of the year.

Industrial production and the trade balance may have also contributed to the quarter-on-quarter slowdown in economic growth. Outstanding performance in November was followed by a decline in industrial production and foreign trade in December. Industrial production is likely to have been influenced by significant one-off, presumably temporary factors, such as holidays and the bad weather. Consequently, the nearly 12% month-on-month decline as shown by the CSO statistics should be treated with care. Industrial production was flat throughout Q4; and the forward-looking indicators continue to suggest that external demand remains very robust.

Similar developments took place in foreign trade: the goods surplus fell in December after a strong outturn in November. Nevertheless, the trade surplus rose to EUR 3.6 billion in 2010 as a whole from EUR 2.3 billion a year previously.

The rate of private sector earnings growth slowed significantly at the end of 2010. The December data showed a more than 2% decline in annual earnings in 2010 relative to the previous year; however, the information content of the overall earnings data is very low, due to the postponement of bonus payments from the end of the year. But regular pay growth was also subdued. The 3% increase in regular pay suggests a further decline relative to the low outturn for 2009. The downward effect on regular pay of the loose labour market is largely as expected, but more robust statements on total pay can only be made when the data for January–February bonus payments become available.

The number of registered unemployed rose significantly, by some 30,000, reaching 684,000 according to January data. The sharp rise in the number of newly registered unemployed in the month accounted for the larger part of the increase in the number of unemployed, with the number of those leaving the registry remaining broadly unchanged relative to previous months. Changes to the public work programmes may be in the background of these developments. That suggests a possible reversal of current labour market trends in the coming months.

Financial market developments

Sentiment in international financial markets has remained generally positive in the period since the Council's January interest rate decision. The markets' generally upbeat mood was only temporarily dampened by the events in Egypt, with most market indicators reflecting strong investor risk appetite: risky asset prices continued to rise, with the result that a number of leading equity indices returned to pre-Lehman levels. Developed country corporate CDS indices and emerging country sovereign bond indices fell, and the VIX index, a popular measure of investor sentiment, again approached the lowest levels seen since the outset of the financial crisis. Apart from a temporary drop in the price of gold, the rise in commodity prices was practically uninterrupted. The US dollar fluctuated in a relatively wide band, before closing the period virtually unchanged against the euro, while appreciating against the Swiss franc and depreciating against the Japanese yen.

Positive sentiment was also supported by indications that the quantitative easing policy of the US Fed would continue as originally planned, in addition to mostly benign macroeconomic data and corporate financial reports from the US and Europe. Following the spectacular improvement in the first part of the period, there was a sharp increase in perceptions of the risks associated with the PIGS economies in early February. However, it is difficult to explain these sharp fluctuations by fundamental factors. Rather, rapid changes of mood are likely to have been a factor at work. Hungary's risk indicators recently have co-moved more closely with risk premia of peripheral countries than with the average of the CEE region, which may represent a risk to future domestic market developments. Furthermore, even though global investor sentiment remains positive, strong capital outflows from emerging markets in recent weeks may be a warning sign.

In the first part of the period, continued strong improvement in perceptions of the risks associated with the Hungarian economy which began in January was also supported by positive global investor sentiment. In addition, the recovery in foreign participants' confidence in Hungarian economic policy may also have played a role. However, it is difficult to explain the latter by fundamental factors; the strongly positive attitude towards the Government's package of policy measures is more likely to have been accounted for by mood swings. And, as several analysts subsequently pointed out, this greater optimism could turn around rather quickly if the volume and structure of the announced measures deviate significantly from expectations. A more cautious attitude was also reflected in domestic asset prices in the latter half of the period.

Changes in financial market indicators during the month showed similar profiles: asset prices rose sharply and risk premia fell over the period to mid-February, followed by a significant, albeit partial, correction in the second half of the period. The Hungarian five-year sovereign CDS premium reached its low point at 285 basis points. The 115 basis point fall in the premium relative to early January was a significant improvement in relative terms. But thereafter the premium rose back to 310 basis points, while risk premia in other countries of the region rose to a lesser extent. The spread of the five-year ahead five-year money market rate over the comparable euro-area rate rose above 300 basis points from its low of 272 basis points; and the sharp fall in the spread on five-year Hungarian euro-denominated bonds over German bonds also faltered, thereafter remaining fairly stable at levels around 320 basis points.

The forint exchange rate fluctuated in a relatively wide band of 3%–5% against the major currencies in the past month. The rapid appreciation at the beginning of the period was followed by a correction and then a subsequent appreciation. As a result, the forint strengthened from EUR/HUF 274 to 270 against the euro, from CHF/HUF 210 to 208 against the Swiss franc and from USD/HUF 202 to 198 against the US dollar. The Hungarian currency outperformed other currencies of the CEE region, appreciating the most against the Polish zloty. Implied exchange rate volatilities showed a mixed picture; however, risk reversal spreads and indicators of the negative skewness in the probability distribution fell materially.

Non-residents significantly increased their long forint positions in the past month. They purchased a net HUF 220 billion of forints in the spot foreign exchange market, about one-third of which was linked to the creation of synthetic long forward positions. In addition, they increased their holdings of government securities by HUF 150 billion, with longer-dated bonds accounting for the largest part. Their holdings of MNB bills rose by a total of HUF 30 billion. In the swap market, non-residents took net short positions in the forint in the amount of some HUF 270 billion; however, there was no tension in the FX swap market during the month.

The auctions conducted in the primary market of government securities had mixed results. In the beginning of the period, issues were oversubscribed and auction yields fell, with the results of government bonds auctions being particularly positive. Although demand for bonds remained strong in the second half of the period, auction yields rose; and demand for discount treasury bills at some of the auctions held in the month fell.

Government bond yields in the secondary market largely followed movements in other financial indicators. Yields began to rise from early February, after falling significantly in the first part of the period. As a result, yields were up by 30–40 basis points following a decline of some 70–100 basis points since the beginning of the year, with benchmark yields on securities issued with original maturities of over one year moving into a range of 7.0%–7.5%. After declining sharply, interbank rates rose back to their level a month earlier. Consequently, the long end and the middle of the curve fell by some 20–30 basis points. At the short end, yields changed only a little, being consistent with a 6.5%–6.75% central bank base rate at the end of the year.

Market prices suggest a moderation in expectations of an official interest rate hike. Quotes of 1x4 forward rate agreements, i.e. of the three-month interest rate in one month's time, imply a greater probability of the Bank's key policy rate remaining unchanged than being raised by 25 basis points at the Council's Monday meeting. Although FRA prices show a moderate upward trend depending on the beginning of the term, this implies that the possibility of another interest rate increase is fully priced in over a longer horizon of at least six months. The favourable inflation data also played a role in the moderation in expectations of an increase in interest rates.

According to the latest Reuters poll of economists, 26 respondents expected the Monetary Council to leave interest rates on hold at its policy meeting on Monday, with one expecting a 25 basis point increase. The majority of economists expected the central bank base rate to remain at its current 6.00% level until the end of 2011. Of those expecting a different base rate, more expected interest rates to be reduced (typically to 5.5%) than raised (typically to 6.25%).

The majority of respondents expected an interest rate easing cycle to begin in 2011 Q2 or Q3. A separate question asked analysts about the level at which the current cycle would reach its peak and about whether the cycle had already ended. Ten analysts believed the current cycle had already ended and four expected that rates would be raised further.

Position of the banking sector

Outstanding lending to companies continued to decline in January 2011. According to preliminary estimates, outflows from the banking sector were high in the month. The stock of forint loans continued to increase due to transactions, while that of foreign currency loans fell sharply. There continued to be little sign of a turnaround in corporate lending. Similarly, the household credit market continued to give no hint of a shift in the trend; however, outflows were smaller than in December 2010. Net flows of forint lending were positive, while those of foreign currency lending were negative.

Lending growth is expected to recover this year, despite negative short-term trends. Net lending flows to the corporate sector may turn positive first (by the end of H1), followed by an upturn in lending to households. However, the January data suggest that downside risks continue to be high. 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 servicing costs may pose a risk to the recovery of demand for credit. On the supply side, uncertainty caused by the special levy on banks, on the one hand, and a deterioration in loan quality, on the other, may have a negative impact on credit supply.

As far as the assessment of liquidity risks is concerned, the volume of foreign liabilities and outstanding swaps of banks remain a key factor. While in December outflows of funds were significant, in January there were massive inflows of some HUF 258 billion, according to preliminary estimates. Foreign currency funds accounted for a smaller part of inflows. That acted to reduce the volume of outstanding swaps.

In 2010 Q4 the quality of bank loans to the corporate sector continued to deteriorate. The ratio of non-performing household loans to the total continued to rise slowly in the period, reaching 11%. Loan losses as a proportion of total outstanding lending rose above 3%, an increase relative to the end of September. However, banks restructured a substantial amount of household loans in the final quarter, which was a factor offsetting the effect of credit quality deterioration and provisioning for loan losses. In contrast to the household sector, the proportion of non-performing corporate loans to the total fell (standing at 12.4%), mainly on account of write-offs and loan sales. According to information derived from the Bank's latest lending survey, more intense restructuring by banks also acted to improve portfolio quality, mainly in the case of project finance loans. The downward effect on profitability of loan loss provisions for credit exposure to the corporate sector was also smaller, falling to 2.6% from levels around 3% at the end of September. The negative impact on profitability of provisions for corporate and household loans was consistent with the projection in the 2010 November *Report on Financial Stability*.

Pre-tax profits of the banking sector and branches were HUF 73 billion in 2010, a considerable decline compared with HUF 294 billion a year previously. The profitability indicators also fell as pre-tax profits declined. Twelve-month rolling ROE fell to 2.8% and ROA to 0.2%. The special levy on banks (recorded by the sector as a cost rather than as a tax) and one-off items were major factors contributing to the decline in profitability relative to 2009. Excluding these, the banking sector's profitability would have been comparable to that recorded at end-2009. This suggests that banks were able to offset higher provisions for household and corporate sector loans by raising their interest margins. In addition to the decline in profitability, there was a strong increase in asymmetries across banks. The sector's aggregate capital adequacy ratio rose in December, reaching 13.4% by the end of 2010.

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

After reviewing the latest macroeconomic news and financial market developments, Council members discussed whether the tightening of monetary policy to date was large enough to ensure that inflation was consistent with the target over the medium term. The majority of Monetary Council members agreed that as long as the size of shocks to energy and unprocessed food prices was greater than previously expected, continued very subdued domestic demand would act as a restraint on price and wage increases. In the Council's judgement, inflation developments in the coming months would continue to be shaped by upward and downward effects, and therefore there was a high degree of uncertainty surrounding the short-term outlook for inflation.

Council members judged that although the January outturn for inflation had been lower than the Bank expected, inflation developments in the period since publication of the November *Quarterly Report on Inflation* had not been more benign overall than the path outlined in the projection published in November. The January outturn for the services price index was viewed favourably by some members, given the role of the January indices as a benchmark for the latter part of the year, as had been the case in previous years. It was also argued that it could not be decided based on one data point whether the positive developments in service sector prices would be sustained. However, rises in commodity and unprocessed food prices were higher than in the baseline projection in the November *Report*. In the Council's judgement, although weak domestic demand might reduce the scope for firms to pass on part of their costs, several members thought the risk of a greater pass-through of the price shocks to core inflation items in the coming months was significant.

Monetary Council members agreed that a lack of detail about the structure of the Government's planned measures to improve fiscal balance contributed to uncertainty about future inflation developments.

Referring to the December earnings data, several members of the Monetary Council noted that moderate growth in regular pay in the private sector over the past two years, closely linked to the loose labour market, might help bring down inflation in the longer term. However, the Council judged that tax optimisation, associated with the changes to personal income taxation, may have been an important factor contributing to low bonus payments in December, and therefore a more accurate assessment could only be made after bonus payments data for early 2011 became available.

Members were of the view that lower-than-expected domestic consumption might also contribute to a decline in inflation. Several members noted that there had been little sign yet of a turnaround in the banking sector's ability and willingness to lend. Consequently, household borrowing continued to be lower than repayments, with the result that the sector's net saving remained high. One member noted that the extent to which the effects of the commodity price shocks and windfall taxes were passed on during the recovery in domestic demand could be crucial for the longer-term inflation outlook.

The Monetary Council also reviewed developments in perceptions of the risks associated with the Hungarian economy, in addition to recent inflation developments. Members agreed that the decline in Hungary's risk premium in recent weeks could be related in part to expectations about the Government's planned measures aimed at improving fiscal balance and in part to the Bank's commitment to meeting the inflation target, as reflected in the Council's decisions to raise interest rates.

The overwhelming majority of Council members were of the view that a decision whether to raise interest rates further to meet the inflation target could only be made after the macroeconomic data to be released in the coming months, the details of the Government's measures and the March *Report* projection became available. An argument in favour of a reduction in interest rates was that a lower base rate would impart a stimulus to the economy.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Six members voted to maintain the base rate at 6.00% and one member voted for a reduction in the base rate of 25 basis points.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 6.00%	**6**	Péter Bihari, Csaba Csáki, Ferenc Karvalits, Júlia Király, Judit Neményi, András Simor
In favour of reducing the base rate to 5.75%	**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

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 28 March 2011. The minutes of that meeting will be published at 2 p.m. on 6 April 2011.