MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

28 MARCH 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

In the baseline projection prepared by Bank staff, inflation eases back to the 3% target by the end of 2012 without further monetary tightening. Average annual inflation is likely to remain around the 4% level throughout 2011, due to the pass-through of rises in global energy and unprocessed food prices to domestic consumer prices, and then fall back to 3.4% in 2012.

The loose labour market and low domestic demand may slow the pass-through of cost shocks into core inflation. Although commodity prices have risen sharply in recent months, their pass-through to core inflation has been slower than expected based on historical observations. Services inflation continues to be low, and measures of underlying inflation have fallen after increasing towards the end of 2010. Earnings growth in the private sector remains moderate, although the interpretation of the latest available data is subject to a degree of uncertainty due to delays in end-2010 bonuses until early 2011 and other distorting factors. The unemployment rate is likely to stay above the 10% level for quite a while, with the result that loose labour market conditions may remain for a prolonged period of time. That in turn creates opportunities for companies to improve their profitability by moderating earnings growth instead of raising their prices.

Economic growth is expected to pick up in 2011. Strong export sales are likely to remain the engine of growth, but domestic demand is also expected to begin to recover during the year. The output gap is likely to narrow significantly over the forecast period as a result of stronger-than-potential economic growth but remains negative throughout the period. One reason for this is that a number of headwinds, including rising inflation due to tight lending conditions, high instalments on debt accumulated prior to the crisis, slowly improving labour market conditions and rising commodity prices, are impeding the recovery in domestic demand. Implementation of the Government's Structural Reform Programme (also known as the Széll Kálmán Plan) is likely to restrain domestic demand growth in 2012 and result in a slower closing of the output gap.

In the March baseline projection, corporate lending turns around this year despite the negative developments in the first two months. This slower-than-expected recovery in lending may be explained by supply-side factors. The quarter-on-quarter change in outstanding corporate lending is only expected to turn strongly positive at the end of 2011. Household lending is likely to recover somewhat later, in 2012 H2. The reduction in the tax burden on personal incomes and disbursements to members of real returns on their private pension fund contributions are expected to impart a strong stimulus to household consumption in 2011. But financial savings may also rise, reflecting precautionary motives. The stability of the banking sector is not exposed to direct risks given its high capitalisation level and sufficient liquidity buffers. However, the high level of short-term foreign funding and declining profitability due to credit deterioration and the bank levy may pose difficulties over the period ahead.

Sentiment in international financial markets in recent months has been shaped by the benign prospects for the world economy and rising sovereign risks within the euro area. Country-specific factors also played a role in movements in Hungarian financial asset prices, in addition to global market sentiment. There was little market reaction to the ratings downgrade of Hungary's government debt, given that it had already been priced in. Although Hungary's risk premia continue to exceed those of countries of the CEE region, they have fallen sharply since the beginning of the year, reflecting the market's optimistic expectations about the Government's structural measures. The composition and scope of the actions announced in early March did not deviate materially from expectations and, consequently, did not result in sharp movements in the market. The start of the tightening cycle at the end of November may have contributed to a pick-up in foreign investors' demand for forint-denominated assets; however, that was mainly reflected in an increase in holdings of short-term assets and a slight appreciation of the forint exchange rate. Money market rates and bank interest rates rose in response to the Bank tightening its policy, but the effect of the move was not fully reflected in forward-looking real interest rates, given the rise in inflation expectations at the same time.

The three alternative risk scenarios in the March baseline projection, reflecting the Monetary Council's risk perception, represent both upside and downside risks to the prospects for inflation. The first assumes that the decline in investment during the crisis will last longer than assumed in the baseline projection. Consequently, the current output gap may be smaller, which in turn implies a weaker disinflationary impact. Under the second scenario, firms will be able to pass more of the increases in costs on to prices as the recovery begins, and stronger second-round inflationary pressures may arise compared with those presented in the baseline scenario. One possible reason for this is that inflation expectations are not well anchored. These two risk scenarios point to higher paths for inflation and interest rates. The third scenario assumes that the availability of bank credit to households will be tighter than in the baseline projection. In that case the output gap will narrow more slowly, which implies higher paths for inflation and interest rates.

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

Before taking a decision on interest rates, the Monetary Council reviewed the latest macroeconomic news and financial market developments and discussed the Bank's March *Quarterly Report on Inflation*. Members were unanimous in concluding that the baseline projection in the *Report*, which assumed that the current 6% level of official interest rates might ensure that inflation would come back to the 3% target in 2012 H2, should be taken as the starting point for a policy decision this month.

Once again, several members noted that there continued to be a conflict between growth driven by rising external activity and subdued domestic demand, as had been the case in previous months. These conflicting trends were also reflected in inflation developments. While the shocks to energy and unprocessed food prices had been greater than expected, subdued domestic demand and the loose labour market acted to restrain price and wage increases; and there was little sign of firms passing the special levies on to customers. It was noted that weaker-than-expected demand was mainly attributable to two factors: the slowdown in earnings growth, closely related to the loose labour market, and the increase in instalments on household debt, driven by the appreciation of the Swiss franc. One member noted that the effects of the reduction in personal income taxation had not yet been reflected in consumption. That might be explained by the fact that the extra income arising from the reduction in taxes was earned by those with higher incomes and lower marginal consumption rates.

In addition to inflation developments, the Monetary Council also reviewed recent developments in perceptions of the risks associated with the Hungarian economy. Members agreed that there had been a significant fall in Hungary's risk premium since publication of the previous *Report*. That had been driven in part by positive expectations about the Government's measures to improve the fiscal position outlined in the Structural Reform Programme and in part by the commitment to meet the inflation target, as evidenced by the Council's interest rate increases, as well as by the recovery in sentiment towards emerging market economies.

Several members noted that although the details of the measures included in the Programme were unavailable at the time of the meeting, the restraint on domestic consumption in 2012 from fiscal consolidation posed a considerable downside risk to growth. In connection with the likely effects of the policy package on inflation, several members noted that the measures affecting pharmaceuticals prices and public transport fares might slow the disinflation process. It was also argued that the Government's attempt to achieve a situation whereby administered prices only increased in proportion to increases in costs might partially offset the upward effects of the package on inflation and might contribute to the efficiency of monetary policy over the longer term. One member was of the view that there was also a chance that Hungary's risk premium would fall further after the details of the Programme were worked out. That in turn might reduce inflationary pressures through an appreciation of the exchange rate.

The Monetary Council also considered the alternative scenarios outlined in the *Report*, in addition to the baseline projection. Several members took the view that there was a significant possibility that the cost shocks would be passed through into prices and, as a result, inflation would remain above the target in 2012. The fact that inflation expectations were not well anchored might play a role in this scenario materialising. One member thought that if the scenario assuming a further decline in investment were to materialise, then it would have negative consequences for both inflation and growth, given that a lower level of capital investment relative to the baseline projection would lead to a greater slowdown in potential growth than assumed by staff, and a smaller negative output gap would have a more modest disinflationary impact. Another member, however, felt that the most likely scenario was that banks' ability and willingness to lend to households would be even lower than in the baseline projection. Consequently, the supply of consumer credit might also be weaker than projected over the entire forecast period. As a result, consumption might be softer, i.e. the negative output gap might close more slowly and disinflation might be faster.

Several members noted that, with the interest rate increases and the appreciation of the exchange rate, monetary conditions had tightened in recent months. Members agreed that a further increase in interest rates now was not justified along the path of inflation implied by the *Report*. Discussing the likely effects of the alternative scenarios on monetary policy, one member noted that although, according to the baseline projection in the *Report*, it was necessary to maintain the base rate at the current 6% for a longer period in order to bring inflation back to the target, a reduction in the base rate might be justified if the recovery in lending turned out to be slower than expected and domestic demand to be weaker than projected. By contrast, tighter monetary conditions might be needed if the pass-through of shocks into consumer prices turned out to be faster. One member also noted that developments in monetary conditions in Hungary were not independent from those in major markets, and in particular from interest rate conditions in the euro area. That was one reason why a faster-than-expected tightening cycle by the European Central Bank in response to a further increase in inflation risks might leave less room for manoeuvre in Hungarian monetary policy.

After the discussion, the six members unanimously voted in favour of the proposition to maintain the base rate at 6.00%.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 6.00%	**6**	Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, Ferenc Karvalits, Júlia Király, András Simor

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

Andrea Bártfai-Mager
János Cinkotai
Ferenc Gerhardt
Ferenc Karvalits
Júlia Király
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 18 April 2011. The minutes of that meeting will be published at 2 p.m. on 5 May 2011.