MINUTES
OF THE MONETARY COUNCIL MEETING
18 APRIL 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 March 2011 annual CPI inflation stood at 4.5% and core inflation at 2.5%. Inflation on these measures rose by 0.4 of a percentage point and 0.6 of a percentage point respectively relative to the previous month. Developments in CPI inflation were consistent with the baseline projection; however, the pattern of change was slightly different from expectations. Part of the surprise reflected one-off, short-term influences. But the larger part of it reflected the pass-through of cost shocks to core inflation. Increasing price pressures from the cost side led to a sharp pick-up in unprocessed food price inflation and a more moderate increase in industrial goods and services inflation. The fluctuation range of trend inflation indicators rose to the levels observed in 2010 H2.

The February industrial production data were evidence of robust growth, in line with the projection in the Bank's March *Quarterly Report on Inflation*. However, this production growth was mixed, given that most of the pick-up was driven by strong economic activity abroad, while domestic industrial sales were subdued. According to seasonally adjusted data, Hungary's goods surplus soared to historical highs: the January–February cumulative surplus amounted to EUR 844 million, up from EUR 592 million in the same period of the previous year. Robust export growth continued in February, consistent with the sharp recovery in industrial production. By contrast, the rate of import growth slowed, suggesting that one-off factors may also have played a role in the strong increase in imports in the first month of 2011. The February industrial production and foreign trade data suggest that the contribution of net exports to growth may have been significant in early 2011. Measures of global economic activity also reflect the strength of external demand.

According to National Employment Service data, the numbers of jobseekers, new jobs and of unemployed people changed little in March. This suggests that conditions in the labour market remain loose, which in turn may cushion inflationary pressure from the recent price shocks.

Financial market developments

The reduction in perceptions of the risks associated with the Hungarian economy continued in the first two weeks following the Monetary Council's March interest rate decision. That was reflected in most asset markets: the forint exchange rate appreciated against all the key international currencies; yields at maturities of more than one year fell by 20–25 basis points; risk premia declined further; and non-residents continued to take long forint positions and to purchase forint-denominated assets. During the last week of the month, however, there was a reversal in domestic asset prices in response to the deterioration in global sentiment, although the extent of the correction varied across the various sub-markets. Overall, the exchange rate remained broadly unchanged against the euro and the Swiss franc; benchmark yields on government securities at maturities beyond one year fell by around 10 basis points; and indicators of risk (CDS prices, foreign currency bond spreads, the spread of the five-year forward rate five years ahead over the euro) eased back to around 240–250 basis points.

There has recently been a clear improvement in market sentiment towards Hungary. But international comparison suggests that this improvement can be traced in large part to regional trends, with the role played by country-specific factors diminishing in the most recent weeks. An indication of this is that in recent months foreign currency bond spreads and CDS premia have fallen nearly identically in countries with similar risk characteristics to those of Hungary.

Based on market expectations, the main scenario remains that the Monetary Council will hold the key policy rate unchanged in the short term. Both market quotes and analysts' expectations suggest that market participants do not expect official interest rates to change in the coming months.

Forward rate agreement (FRA) rates fluctuated narrowly in the past three weeks. Currently, FRA rates reflect a greater probability that interest rates will remain on hold until 2011 Q3, while there is an equal probability that interest rates will be maintained or raised by 25 basis points by the end of the year.

Analysts unanimously expect the Council to leave interest rates unchanged at its April policy meeting. But their views on the Bank's interest rate policy are divided looking further ahead: according to the results of the Reuters poll of economists, the majority view is that the tightening cycle has already ended. Two of the 21 respondents expect interest rates to be raised in June. And the market consensus is for the base rate to be 6.00% at the end of the year, with forecasts ranging from 5.50% to 6.75%.

Position of the banking sector

Outstanding bank lending to the corporate sector continued to decline at a rapid pace in March 2011. This decline mainly reflected a continued fall in foreign currency loans; the stock of forint lending rose only marginally during the month. Outstanding lending to households also continued to fall, reflecting declining foreign currency lending and the low volume of new forint lending.

Non-performing loans were 11% as a proportion of the outstanding total at the end of 2010. Loan losses rose above 3% of the total stock of loans. Non-performing loans fell to 12.4% as a proportion of the stock of lending to companies in the final quarter. However, this reflected the effects of write-offs and loan sales as well as the increasing stock of restructured loans. At the end of 2010, loan-loss provisions reduced banking sector earnings by 2.6%.

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

Monetary Council members agreed that developments in the economy and inflation had been consistent with the baseline projection in the March *Report* over the period since the previous interest rate decision. Inflation might exceed the target significantly in the short term due to the cost shocks hitting the economy; however, it might fall back close to 3% by the end of next year, on the assumption that the base rate remained constant.

In the Council's judgement, the March outturn for inflation was broadly in line with the projection produced by Bank staff. Several members noted that at the disaggregated level the inflation data were less benign, with core inflation exceeding the projection. However, members agreed that more time was needed to assess how long this process would continue. Some were of the view that the core inflation data might suggest that while the speed of the longer-term pass-through of cost pressures to consumer prices had fallen, its degree had not changed relative to previous years, and subdued domestic demand might delay the pass-through only temporarily.

Several members noted that at present it was particularly difficult to judge the outlook for inflation because the volatility of agricultural and commodity prices had increased sharply recently, with the resulting uncertainty being reflected in the dispersion of market forecasts. However, some members thought that a reversal of the significant rise in oil prices in the past weeks could not be ruled out, especially if the conflict in Libya was resolved. One view was that it seemed possible that the increase in certain food prices would reverse in the coming months; however, several members said that they expected that unprocessed food prices would continue to increase for some time to come. On another view, prices had risen somewhat less strongly in the first quarter as a result of the Government's administrative measures.

Some members argued that despite the loose labour market conditions and the slow pass-through of the cost shocks, it could not be ruled out that firms' stronger willingness to pass increases in their costs on to customers would lead to rising inflationary pressure, consistent with one of the risk scenarios presented in the March *Report*. In addition, some members cautioned that the decline in investment might have a negative influence on potential growth, given the time it took for the Government's measures to have their effect in stimulating investment. Consequently, the negative output gap, playing a role in offsetting inflationary pressures, might close faster than expected.

Members agreed that there had been a slight reduction in perceptions of the risks associated with the Hungarian economy and, as a result, investor demand for forint-denominated assets had increased. This had been driven in large part by regional trends and to some degree by Hungary-specific factors. Several members noted that the Government's Structural Reform Programme had contributed to the improvement in investor sentiment. Other members, however, were of the view that at present it was difficult to assess the risks surrounding the Programme.

Several members argued that the Government's commitment to implement the Programme and the announcement of concrete measures could provide protection against the negative impact of external events on the market's perception of sovereign risk.

In evaluating the policy choices, all members proposed to maintain interest rates at their current level. They agreed that, based on the latest information, inflation could be in line with the baseline projection and the alternative risk scenarios presented in the March *Report*. It was also argued that the recent interest rate decision by the European Central Bank had no influence on Hungarian monetary policy, given that it, and its communication, had not changed market participants' expectations and had been in line with the projection in the *Report*. Several members noted, however, that the Council should pay particular attention to assessing future developments in commodity and food prices, as well as their potential second-round effects when deciding on interest rates in the coming months.

After the discussion, the seven 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%	**7**	Andrea Bártfai Máger, János Cinkotai, Ferenc Gerhardt, Ferenc Karvalits, Júlia Király, György Kocziszky, András Simor

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

Andrea Bártfai Máger
János Cinkotai
Ferenc Gerhardt
Ferenc Karvalits
Júlia Király
György Kocziszky
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 16 May 2011. The minutes of that meeting will be published at 2 p.m. on 8 June 2011.