MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

16 MAY 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 April 2011, annual CPI inflation was 4.7% and core inflation was 2.7%. On both measures, inflation rose by 0.2 of a percentage point relative to March and was higher than the projection in the Bank's March *Quarterly Report on Inflation*. The increase in inflation was mainly accounted for by the recent sharp rise in the prices of commodities, especially oil and agricultural products, and its faster-than-expected pass-through. This also contributed to the significant increase in processed food prices, one of the items included in the core measure of inflation. By contrast, prices of tradables and services continued to rise modestly, reflecting weak domestic demand. As a result, the measures of underlying inflation indicate a moderate 2%–3% upward price pressure.

According to data adjusted for seasonal fluctuations and calendar effects, Hungary's GDP grew by 2.2% in 2011 Q1 relative to the same period of the previous year and by 0.7% relative to the previous quarter. Although detailed GDP data are not yet available, strong external demand is likely to have remained the major factor driving growth. By contrast, the performance of sectors producing for the domestic market may have remained in its trough. The GDP data was slightly lower (by 0.2 percentage points) than the short-term projection in the March *Report*.

According to preliminary industrial production data for March, the output of the sector fell after rising robustly in January–February. Despite this, industrial output still grew at a rate of 3.2% during Q1 relative to the previous quarter. This reinforces the view that rising industrial production may have contributed materially to economic growth in the early months of the year. According to February's foreign trade data, the volume of goods exports grew by 20.6% relative to a year earlier and that of imports by 14.6%. This strong export growth appears to be consistent with the pick-up in industrial production.

The picture for domestic demand continued to be weak, as suggested by the most recent data. The volume of retail sales stagnated in February, and the household confidence index has fallen in the past few months. This suggests that household consumption demand may have been subdued in Q1. The housing market continued to weaken in the period, with the number of occupancy permits and building permits issued falling by 35% and 51%, respectively, relative to the same period of the previous year.

The February earnings data continue to be consistent with the view that private sector earnings growth remains subdued, due to persistently loose labour market conditions. The rate of earnings growth, adjusted for seasonal fluctuations and the effects of delayed bonus payments, has been below 4% during recent months, which is significantly lower than in the period preceding the financial crisis. The different cyclical positions of the various sectors have also been reflected in pay developments: earnings growth has been faster in manufacturing and the financial sector and slower in market services. Government sector earnings growth has stagnated in recent months. According to institutional data, the number of employees in the private sector stagnated in February, and this was consistent with whole-economy Labour Market Survey data for January–March.

Financial market developments

The reduction in perceptions of the risks associated with the Hungarian economy continued in the period following the April policy decision, albeit at a slower pace than previously, as reflected in most segments of the financial market. Over the past month, the forint exchange rate appreciated modestly against the major currencies; yields on government securities at maturities of over one year fell by 5–10 basis points; risk premia edged lower; and non-residents continued to take long forint positions and to purchase forint-denominated assets.

Improved sentiment in international financial markets was the backdrop against which the modest decline in Hungarian risk premia occurred. Regional and country-specific factors played a role in the reduction in perceptions of the risks associated with the economy. Throughout the Central and Eastern European region, the response of asset prices to the temporary global premium shocks of recent weeks has not been as sharp as it was at the end of last year or during the first few months of 2011.

Over the past several months, Hungarian risk premium indicators improved moderately compared with the average for the region: the forint appreciated against most CEE currencies, and foreign currency bond yields and credit default swap premia fell to a greater degree than elsewhere in the region. However, there has been no further improvement in Hungary’s relative position in recent weeks.

Market expectations about the future path of official interest rates have not changed materially in the past month. Although both the March and April inflation data were a negative surprise for analysts, market expectations about monetary policy over the short and medium term do not seem to have changed substantially. Based on market expectations and analysts’ consensus view, the main scenario remains that the Monetary Council will hold the key policy rate unchanged over the short term. Forward rate agreement (FRA) rates fell steadily over the past month. FRA rates continue to reflect a near 100% probability that interest rates will remain on hold in the coming months. Whereas the market had previously assigned a greater probability to the possibility that the Monetary Council would increase rates by 25 basis points rather than maintain them at the six to twelve-month horizon, analysts have now clearly revised down their forecasts to levels close to 6.00% for this period.

According to the results of the May Reuters poll, two-thirds of economists expect the base rate to be 6.00% at the end of the year. The differences on the upside and on the downside are roughly equal and range within 50 basis points of the current base rate level. Forecasts for the end of 2012 range from 4.50% to 6.50%, with the median of expectations being 5.75%, the same result as in the April survey. The dispersion of base rate forecasts for both 2011 and 2012 has declined significantly, suggesting that expectations have become more homogenous.

Position of the banking sector

Following the steady decline in previous months, outstanding lending by the seven large Hungarian banks to the corporate sector rose mildly in April according to preliminary data. This increase resulted from a smaller decline in the stock of foreign currency loans. The average APR on loans to the corporate sector barely changed in March. Still, since the beginning of the tightening cycle the average interest rate on loans of up to the equivalent of EUR 1 million rose by 0.6% and that on loans of over the equivalent of EUR 1 million by 0.86%. The decline in outstanding household lending continued, reflecting the fall in the stock of foreign currency loans and the low volume of new forint lending. Outstanding lending to households fell by a net total of HUF 24 billion. The average APR on both housing and home equity loans rose in March, with the former increasing by 0.66 percentage points and the latter by 1.38 percentage points, relative to November 2010.

According to preliminary data, the ratio of non-performing household loans rose further in 2011 Q1, whereas loan losses as a percentage of total outstanding lending fell. However, the loan loss coverage ratio remained broadly unchanged. The decline in the ratio of non-performing corporate loans (NPLs) in 2010 Q4 was only temporary, as the Bank had expected, and the ratio of NPLs rose again in 2011 Q1. The negative impact on earnings of provisions for corporate loans declined further, but loan loss coverage remained at previous levels.

In 2011 Q1, pre-tax profits of the banking sector and branches were down from HUF 148 billion recorded in the same period of 2010. Nevertheless, earnings developments were benign, as total banking sector profits amounted to only slightly more than HUF 70 billion in 2010 as a whole, due to the large losses registered in the second half. The sector's aggregate capital adequacy ratio remained broadly unchanged in the first few months of 2011.

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

Monetary Council members agreed that inflation might significantly exceed the target in the short term, due to the cost shocks hitting the economy, but that it might fall back close to 3% by the end of next year, assuming that the base rate remained constant. In the Council's judgement, risks to inflation remained both on the upside and the downside: commodity price rises and their faster pass-through posed upside risks, while weaker-than-expected domestic demand posed downside risks.

During the period since March, both inflation and core inflation have been higher than the projection in the Bank's March *Quarterly Report on Inflation*. Some members were of the view that the pass-through from unprocessed food prices to processed food prices may have been greater, which may have played a role in the pick-up in inflation. However, it was also argued that, based on the pace of price increases in the first four months of the year, the rise in commodity prices had not been exceptionally sharp, apart from the intense one-off increase in the price of sugar, and a potential reversal in commodity prices might moderate the inflationary effects. Although the international price of crude oil had risen overall in recent months, commodity market prices of finished products influencing movements in vehicle fuel prices had risen less sharply and the forint had appreciated against the US dollar. In turn, these factors might slow the pass-through into domestic petrol prices. One member thought that unfreezing household energy prices might push inflation higher in the second half of the year. Others argued that a new formula for setting administered prices was expected to be introduced, which would enable the Government to prevent excessive price increases.

Members agreed that slack domestic demand and the negative output gap continued to be the most important factors contributing to the disinflation process. However, members' views were divided over the impact on household consumption of the reduction in tax rates and disbursements to members of real returns on their private pension fund contributions. Several members argued that high indebtedness and high payment-to-income ratios would lead to further balance sheet adjustment. Consequently, households would use part of any additional income to reduce existing debt. Other members were of the view that it could not be ruled out that consumption would rise more strongly than in the baseline projection for inflation, which in turn would add to inflationary pressure. The majority of members thought that services and tradables prices continued to rise at the moderate pace of the recent period, but it was also argued that the most recent data suggested a slight pick-up in the rate of price increases.

Council members agreed that there had been a strong and sustained reduction in perceptions of the risks associated with the Hungarian economy in recent months. Several members, however, noted that Hungary's relative position in Central and Eastern Europe had not improved in recent weeks. There was a division of views about the likely impact of the sovereign debt problems within the euro area on perceptions of the risks associated with the economy. As to the future, several members thought that a worsening of the debt crisis could not be ruled out, which might have a negative influence on perceptions of the risks associated with forint assets. Members agreed that the Government's commitment to the Structural Reform Programme, and the announcement and implementation of concrete measures could have a positive impact on the market's perception of sovereign risk and provide protection against the negative impact of external events.

In evaluating the policy choices, all members proposed to maintain interest rates at their current level. Most members argued that, based on the latest information, inflation could ease back to around the Bank's 3% target by the end of 2012, and therefore it was justified to maintain current monetary conditions. The upside and downside risks to inflation, originating from uncertainty surrounding domestic demand and external influences, were seen by some members as supporting a decision to leave interest rates unchanged.

In reviewing recent decisions by foreign central banks, some members noted that monetary conditions in Hungary may have eased in comparison with other countries of the CEE region, due to the interest rate actions of the European Central Bank (ECB) and the Narodowy Bank Polski (NBP). Others, however, argued that the MNB had raised interest rates earlier, and these moves might have faster and stronger effects, due to the delayed pass-through, than the ECB's and the NBP's interest rate hikes. All this may have contributed to stabilising expectations about interest rate policy, the exchange rate and inflation. The March earnings data, scheduled to be released after the Council's interest rate decision, would be particularly important for the Council's next policy decisions, as these were unlikely to be distorted by the delay in wage payments from the end of 2010 to early 2011. Several members noted that the Bank's next *Quarterly Report on Inflation* would help the Council assess the outlook for inflation and take its decision on interest rates in June.

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 20 June 2011. The minutes of that meeting will be published at 2 p.m. on 6 July 2011.