MAGYAR NEMZETI BANK

MINUTES
OF THE MONETARY COUNCIL MEETING
20 JUNE 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 the 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 Staff's assessment of macroeconomic and financial market developments

As described in the Bank's June *Quarterly Report on Inflation*, cost pressures from higher global commodity prices have accounted for the increase in domestic inflation since early 2011. Higher commodity prices fed through into processed food prices, and the increase in oil prices was quickly reflected in domestic vehicle fuel prices. In the *Report* projection, consumer price inflation remains around 4% in the short term. The projection is based on the assumption that global commodity prices will fall gradually, which in turn will help moderate inflation in the medium term. The combination of weak domestic demand and loose labour market conditions is expected to mitigate possible second-round effects. In the medium term, administered energy prices are likely to reflect the cost increases in previous quarters, which is expected to slow the decline in inflation temporarily in early 2012. In the baseline projection, maintaining interest rates at their current level over a sustained period helps bring inflation back to the 3% level consistent with price stability by the end of 2012.

Economic growth continues to be dominated by opposing forces: external demand is likely to remain the main driver of the recovery from recession, with domestic demand is expected to pick up only gradually. Industrial production growth has been almost uninterrupted since early 2009, led by strong global demand, while the performance of the service sectors remains weak. The staff's assumption is that actual output remains below its potential level by more than 3%. Capacity utilisation in sectors producing for export markets may have reached its long-run historical level, while significant spare capacity remains in the services sector.

The outlook for domestic growth continues to be determined by a prolonged period of balance sheet adjustment by the private sector following the financial crisis and by the measures of the Government's Structural Reform Programme and Convergence Programme. In the current projection, Hungarian economic growth is slightly higher than its potential this year and next year, but the output gap still remains negative over the entire forecast period. Robust external demand continues to be the key driver in closing the output gap, while domestic demand items remain below their medium-term equilibrium levels over a longer period.

Household consumption expenditure has stagnated since the end of 2009 and shows no sign of picking up. A number of factors suggest that the period of weak consumption will be more prolonged than the Bank's previous forecasts had assumed. The significant surplus incomes for households resulting mainly from the reduction in personal income tax rates and bonus payments around the end of last year did not translate into increased consumption. Precautionary motives continue to strongly influence consumption decisions. As a result, the saving rate has increased further from its high level reached during the crisis. Loan repayments continue to be higher than new borrowing. The current weakness of bank lending reflects both supply and demand factors.

In the baseline projection, consumption remains below its longer-term trend for quite some time. Consumption continues to be determined by the uncertain outlook for income and a prolonged period of balance sheet adjustment due to high household debt, which in turn is aggravated by increases in instalments on existing foreign currency loans. The relief programme for distressed borrowers is likely to have only limited impact on consumers' cautious behaviour. While disbursements to members of real returns on their private pension funds contributions are expected to provide a boost to household consumption in the short term, the measures of the Government's Structural Reform Programme and Convergence Programme are likely to lead to a temporary decline in disposable income.

Persistently weak domestic demand, tight credit standards and the effect of windfall taxes are impeding the recovery in corporate investment. Although private sector investment rose in Q1, this was related to a couple of large car manufacturers; and other sectors are more likely to increase utilisation of existing capacity and postpone planned investment projects.

The housing market is expected to decline further, due to strong demand constraints and the significant oversupply of housing. The uncertain labour market environment, tight credit terms and the accumulated housing stock have adversely affected the housing market. The Government's programme to help distressed borrowers may provide temporary relief for the most needy. Household investment is only expected to stabilise from the middle of next year.

The economic recovery has not been associated with strong employment growth, due to labour hoarding during the crisis. In the private sector, employment levels have not yet increased, and rising activity is holding unemployment at a historically high level. Employment may recover slowly and gradually as the economy picks up, but, with activity continuing to increase, the unemployment rate may stagnate at the current level of around 10%. Measures to tighten the regulations on disability pensions are expected to lead to a faster pick-up in the activity rate.

The downward effect of loose labour market conditions continues to be strong, and therefore inflationary pressure from the labour market remains weak. This is reinforced by the fact that gross earnings growth in the private sector continued to be moderate in April 2011, at an average rate of 4%. In addition to loose labour market conditions, the reduction in taxes on labour also creates the opportunity for companies to offset the decline in their earnings by reducing labour costs. Overall, loose labour market conditions are expected to remain, associated with moderate gross earnings growth.

Outstanding borrowing by the private sector continued to fall in Q1. Although international experience shows that the pick-up in lending generally follows the economic recovery from recession with a delay, the domestic banking market shows numerous signs of strong constraints on the supply of credit. The stocks of long-term lending to the corporate sector and foreign currency lending to households fell. According to the Bank's latest lending survey, companies found it harder to access bank lending in 2011 Q1. Banks continued to lend mainly to creditworthy borrowers and to compete fiercely for business with them. In the household market, non-price terms remained virtually unchanged. The average APR and interest rate spreads on mortgage loans both rose. Lending to households is expected to pick up from the middle of next year.

Hungary's external position continued to reflect the continued strength of exports led by robust external demand and subdued domestic absorption due to slack consumption and investment activity. As a result, the external financing capacity of the economy rose to around 4% of GDP in 2010, which was high by international standards, with the improvement in the private sector's financing position playing a role.

The economy's external position is expected to improve further in the next few years, driven by the surplus on real economic transactions and rising transfers from the EU, which is only partially offset by the rising income account deficit. In 2011, the improvement in Hungary's external financing capacity is likely to be driven by the sharp deterioration in the position of general government and the improvement in the position of the private sector. In 2012, the general government balance is likely improve due to the measures in the Structural Reform Programme, with net savings of the private sector expected to fall slightly.

Financial market developments

Investor sentiment in global financial markets was predominantly influenced by the slight deterioration in the short-term outlook for economic activity and the recent escalation of the sovereign debt crisis in euro-area periphery countries. Slightly increasing risk aversion, reflecting recent and prospective tightening of policies in the developed economies, may also have contributed to the sharp correction in risky asset prices. The overweighting of safer financial assets within portfolios was an important factor influencing the direction of capital flows, but perceptions of risks associated with emerging markets continued to be relatively low.

Investors' attitude to Hungarian financial assets was influenced by positive sentiment towards emerging markets, the relative stability of perceptions of the risks associated with the CEE region and a couple of country-specific factors. Escalation of the Greek and Portuguese financial crises had only limited impact on the risk premia of the region, with the Hungarian premium only beginning to rise slightly towards the end of the period. The relative stability may have also been supported by country-specific factors such as the positive market reactions to the Hungarian Convergence Programme, the interest rate premium on the forint and the country's strong first-quarter foreign trade performance. Non-resident investors further increased their exposure to Hungarian assets, as reflected by the sharp increase in the sector's holdings of government paper.

As suggested by both market prices and analysts' comments, the consensus view is that the Monetary Council will hold the key policy rate unchanged in the coming months. Moreover, the majority of participants do not expect any change in interest rates during the remainder of the year, given that the upside and downside risks to inflation appear to be evenly balanced. There is little consensus among analysts on the timing and direction of the next interest rate move.

Position of the banking sector

Following the small increase in April, outstanding lending to the corporate sector fell again in May. Since 2010 H2, the spread on both euro and forint corporate loans over interbank rates has stagnated between 2.5 and 2.6 percentage points. In light of the sharp increase in the lending spread since the crisis due to banks' loan losses (it stands between 230–250 basis points), the current level of the spread is considered low. This is particularly the case with euro loans, where the costs of external and foreign currency funding have increased significantly since the crisis. However, low spreads suggests that banks lend selectively, given that only higher credit quality borrowers have access to credit at low spreads. Moreover, it became more difficult for companies to borrow, as the majority of banks tightened further their credit standards. And they expect a further tightening over the period ahead.

The reduction in the outstanding stock of household loans continued in May, reflecting a decline in foreign currency loans and the low volume of new forint lending. Standards on credit to households were also tightened during Q1. At the same time, there was mainly an increase in the cost of credit rather than a tightening in non-price terms, in sharp contrast to the developments in 2010. The gradual increase in official interest rates only partially accounted for the rise in costs, given the more than 100 basis point increase in the APR.

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 and financial market developments and discussed the June issue of the *Quarterly Report on Inflation* produced by MNB staff. In the *Report* projection, by maintaining interest rates at their current 6% level, the 3% target for CPI inflation could be met by the end of 2012.

Council members agreed that the pattern of growth envisaged by the current baseline projection continued to be uneven. On the one hand, domestic growth continued to be driven by the recovery in external activity, while, on the other, domestic demand remained subdued. Similarly, inflation developments were also determined by opposing forces. While the commodity price shock, particularly the higher-than-previous path for the price of oil, would by itself have upward effects on inflation, subdued domestic demand and the loose labour market acted as a brake on price and wage increases. It was also noted that postponing the freeze in household energy prices would change the profile of inflation and raise inflation in the middle of the forecast period.

Several members viewed both the change in the outlook for domestic demand and the further increases in commodity prices as negative developments. In terms of their impact on inflation, however, the two forces counteracted each other. Still, the high volatility of commodity prices increased the risks to the economic outlook. Other members noted that although there was great uncertainty around the future outlook for energy prices, this year's wheat harvest would be stronger and of better quality than last year, which was seen as a welcome development.

It was noted that slower domestic demand growth than previously assumed had been identified as a risk at the time of the March *Report*, and it was incorporated in the new baseline projection based on data becoming available since then. Despite the fact that a number of households had more disposable income to spend this year due to the tax measures enacted in 2010, the debt relief programme and disbursements to members of real returns on their private pension fund contributions, consumption had not recovered materially, due to the necessary balance sheet adjustment by indebted households. The lower path for consumption growth over the entire forecast horizon in the baseline projection also reflected the fact that the new projection incorporated the downward effect on demand of the measures in the Structural Reform Programme and the Convergence Programme.

The Council, in reviewing the economic outlook, discussed in detail the alternative scenarios presented in the *Report*, which suggested both upside and downside risks to inflation. Potential further rises in commodity prices could lead to higher inflation than incorporated in the baseline projection. Members agreed that even with a more aggressive tightening of monetary policy, the Council had limited room to cushion the direct effects of the energy price shock. However, several members noted that the task of monetary policy was to offset the second-round effects of those external shocks by anchoring expectations at a level consistent with the inflation target. It was argued that weak domestic demand might mitigate the second-round effects and that persistently loose labour market conditions exerted strong downward pressure on price and wage increases. Several members noted that the high inflation environment of the past decades increased the danger that second-round effects would arise, but that this might be mitigated by the disinflationary impact of the negative output gap. Members disagreed about the degree to which inflation expectations were anchored. One member noted that inflation expectations had become anchored recently, while others were of the view that expectations continued to be inconsistent with the Bank's inflation target and had even increased recently. The other alternative scenario of a higher inflation path, considered by the Council in taking a decision on interest rates this month, was the escalation of the sovereign debt crisis in euro-area periphery countries, which could result in higher risk premia on Hungarian assets and lead to forint depreciation. By contrast, the scenario of concrete measures to cut expenditure contributing to a reduction in perceptions of the risks associated with the Hungarian economy and an appreciation of the exchange rate might support the disinflation process.

Members agreed that it might be necessary to hold interest rates at their current level of 6% for an extended period in order to ensure that inflation returned to the Bank's 3% inflation target by the end of 2012, particularly in view of the baseline projection and the risks surrounding it. Several members noted that domestic economic developments by themselves could allow for a reduction in interest rates in the short term, but external risks did not support such a move. By contrast, other members noted that if external risks materialised it might be necessary to raise interest rates.

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-Mager, 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-Mager
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 26 July 2011. The minutes of that meeting will be published at 2 p.m. on 10 August 2011.