MAGYAR NEMZETI BANK

# MINUTES
## OF THE MONETARY COUNCIL MEETING
## 25 OCTOBER 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 Macroeconomic and financial market developments

The September outturn for core inflation was in line with the projection in the Bank's September *Quarterly Report on Inflation*. By contrast, the consumer price index was 0.2% below the projection. This difference was accounted for by unprocessed food prices and resulted from a smaller-than-expected effect of the methodological change.

Industrial production continued to pick up in August, with output growing by 4.4% relative to the same period of 2010. This pick-up continued to reflect the strength of Hungarian exports. Manufacturing exports rose by some 5%, in contrast to domestic sales, which continued to decline. The activity data gave a rather mixed picture: growth in new German industrial orders slowed in September, while the domestic business confidence index stopped declining.

Whole-economy earnings grew by 6.5% in August 2011 relative to the same period a year earlier. The annual private-sector wage index was 5.9% in the month, rising slightly relative to July. The number of full-time employees remained flat. Businesses began to introduce flexible employment patterns as economic activity continued to deteriorate, with the result that the number of part-time employees and the share of agency work rose.

According to detailed balance-of-payments data, Hungary's external financing capacity rose to 3.5% of GDP in 2011 Q2. The country's financing capacity, calculated using a top-down approach, fell in August. However, the bottom-up measurement of financing capacity continued to improve, rising to a record twelve-month high. Accordingly, banks' and companies' external debt continued to fall. Household savings remained unchanged in August.

**Financial market developments**

Investor sentiment in international financial markets has fluctuated widely in recent weeks. Changes in risk appetite were mainly dominated by news related to global activity, the handling of the European debt crisis and the euro-area banking sector. The results of the upcoming EU and G-20 summits will have key importance for future movements in asset prices in global markets.

Perceptions of the risks associated with the Hungarian economy have continued to increase over the past month; the CDS premium practically fluctuated around 500 basis points throughout the period, reaching 570 basis points, a two-and-a-half year high. The decline in the premium towards the end of the period was largely accounted for by an improvement in global sentiment. As a result, the gap relative to the emerging-market benchmark countries increased significantly overall, i.e. country-specific factors also contributed to the deterioration in Hungary's relative position, in addition to the increase in the absolute level.

Market analyses focusing on the Hungarian economy reflect a clear increase in risk perceptions. They cite the deterioration in the outlook for growth, concerns about the sustainability of next year's government budget, pressure on the market due to the early repayment option for foreign currency debtors and financial stability risks as the main contributing factors. Nonresident investors were net sellers in the market of forint-denominated assets, reducing their government securities holdings by some HUF 130 billion to HUF 3,829 billion since the Monetary Council's last interest rate-setting meeting. Non-residents did not roll over maturing bond and Treasury bill holdings. The effect of this was also reflected in the government securities auctions. Forint sales by non-residents amounted to some HUF 100 billion in the past month. Some strains were apparent in the FX swap market at the shortest maturities; spreads rose and remained at elevated levels, reflected in part by tensions in the EUR/USD market. By contrast, spreads fell at longer maturities of over three months, in line with developments elsewhere in the region.

The forint exchange rate has fluctuated in a rather wide range of approximately HUF 15, depreciating on the whole by around 3%-4% against the euro and dollar. There was a sharp increase in the negative skewness in the probability distribution of exchange rate expectations during the days preceding the Council meeting. Global, regional and country-specific factors played differing roles in exchange rate movements. Nevertheless, on occasions the forint decoupled significantly from other currencies of the region, due to country-specific factors.

Interest rate expectations have increased materially since the Council's last interest rate-setting meeting, as perceptions of the risks associated with the Hungarian economy increased and the forint weakened sharply. The differential between the base rate and interest rates implied by FRA quotes at the 1x4 and 3x6 maturities exceeded 40 basis points and 100 basis points, respectively. Notably, in contrast to previous months, co-movements between the forint exchange rate and FRA rates have strengthened again, i.e. market participants believe exchange rate developments may be a dominant factor shaping interest rate policy. All of the respondents to the latest Reuters poll expect interest rates to remain on hold at the Council's October policy meeting, with the majority expecting the base rate to be at 6.00% at the end of 2011.

**Position of the banking sector**

The contraction of the banking sector's balance sheet continued in September. The stock of lending to the corporate sector fell further. This decline in the outstanding total reflected an increase in foreign currency loans and a sharp drop in the stock of forint loans. Average interest rates on forint loans were barely changed in August, rising slightly relative to the previous month. The decline in lending to the household sector continued in September. The average APR on housing loans remained unchanged in August. By contrast, the increase in the APR on home equity loans since the end of 2010 continued. The stock of lending to financial enterprises fell sharply in September.

In the first eight months of 2011, pre-tax profits of the banking sector and branches were higher than in the same period of the previous year. In September, however, pre-tax profits fell. This negative result for the month was due in part to provisions for expected losses. The general picture is worsened by the substantial degree of asymmetry across banks. The sector's capital adequacy ratio changed little in September.

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

Council members agreed that slack domestic demand continued to put strong downward pressure on prices. Repayment burdens prompted households to adjust their balance sheets and, as a result, a further decline in domestic purchasing power could not be ruled out over the short term. Credit conditions for companies continued to tighten and corporate sector profitability continued to decline. The slowdown in external demand was already reflected in domestic macroeconomic data.

In the Council's judgement, the uncertainty surrounding the inflation projection had increased, due to external factors and domestic economic policy measures. Members were of the view that the medium-term outlook could be reassessed during the production of the December inflation projection, after actions by the European Union to deal with the sovereign debt problems within the euro area were announced and new information was reviewed. Several members argued that the upward effects on inflation from the indirect tax increase and the depreciation of the forint exchange rate in recent weeks might only be temporary. However, members held the unanimous view that monetary policy should closely monitor potential pass-through into the consumer price index. One member noted that the significant increase in the minimum wage could add to cost-push inflationary pressure. Another member argued that in the current circumstances monetary policy should focus mainly on developments in core inflation adjusted for taxes. Other members, however, emphasised that the Bank's price stability objective had to do with the overall consumer price index and previous experience suggested that it was necessary to keep core inflation below the inflation target in order to maintain price stability. On another argument, the Government's tax measures represented a price shock which was unlikely to wane on the policy horizon, and carried the risk that expectations of persistently high prices could develop.

Members of the Monetary Council agreed that forecasting future changes in perceptions of the risks associated with the economy was the most important source of uncertainty for decision-making. Some members concluded that sovereign debt problems in several euro-area periphery countries might ease over the short term after the details of actions by the European Union were agreed and announced. As a result, investor sentiment might improve in the near term, which could lead to an increase in demand for forint-denominated assets and an appreciation of the forint exchange rate. By contrast, several members noted that, along with the unpredictability of the international environment, early repayments of foreign currency loans and the 2012 government budget gave rise to uncertainties. For some members, the good news was that the level of government deficit continued to be very low compared with other European countries. One member, however, emphasised that the deterioration in the longer-term outlook for growth might jeopardise the sustainability of the fiscal path. Moreover, borrowers' interest in the early repayment option was subdued, in which banks' behaviour might play a role. Some members drew particular attention to the fact that several leading politicians had held out the prospect of expanding the range of opportunities for early repayment of foreign currency debt. If this were to occur, it would adversely affect Hungary's risk perceptions.

On one argument, an increasing number of analysts suggested that the euro-area economy might enter a recession next year, which could also adversely affect Hungary over the medium term. Several members cautioned that funding problems within the euro-area banking sector had intensified and there was a risk that lending would stall. Some members thought that the depreciation of the forint against other currencies of the CEE region and the results of the latest government securities issues reflected an increase in perceptions of the risks associated with forint-denominated assets.

In assessing the various interest rate policy options, the overwhelming majority of members agreed that under the current circumstances the Council should continue with its wait-and-see approach. The latest real economic developments would warrant an easing of monetary conditions, but the sharp deterioration in global risk perceptions and financial stability risks prevented the Council from carrying it to effect. It was also the unanimous view of the majority of members that the medium-term outlook for inflation could be assessed after actions by the European Union to deal with the sovereign debt problems within the euro area and the Hungarian Government's economic policy measures were announced.

Members' views were divided on future desirable monetary policy conditions and their communication. Some members felt that the fact that the European Central Bank was expected to reduce interest rates in the near future called for maintaining the present wait-and-see approach and, consequently, the premium on forint-denominated assets might rise. On one argument, Hungarian monetary policy was unable to respond to external shocks arising from the euro-area sovereign debt crisis. However, several members thought that if external conditions did not improve and the increase in Hungary's risk perceptions persisted, inflation risks might increase and tightening monetary conditions could not be avoided later on. One member cautioned that higher inflation and reducing debt though inflation could not represent a realistic economic policy alternative. The Bank's mission and mandate did not allow for this to happen; and in a small, open country where the state was indebted to a significant degree in foreign currency this could not be a successful strategy.

After the discussion, the Chairman invited members to vote on the proposals put to the Council. Six members voted to maintain the central bank base rate at 6.00% and one member voted to raise it by 25 basis points.

**Votes cast by individual members of the Council**

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| ***In favour of maintaining the base rate at 6.00%*** | **6** | Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, Ferenc Karvalits, György Kocziszky, András Simor |
| ***In favour of raising the base rate to 6.25%*** | **1** | Júlia Király |

**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

Roland Nátrán, Deputy State Secretary of the Ministry for National Economy, was present as the Government's representative.

**The Council will hold its next policy meeting on 29 November 2011. The minutes of that meeting will be published at 2 p.m. on 7 December 2011.**