MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

29 NOVEMBER 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

In October, the consumer price index rose by 0.3 percentage points to 3.9%, while core inflation remained unchanged at 3.0%. The outturn for inflation was 0.2 percentage points higher than in the September projection, whereas core inflation was consistent with the Bank's expectation. The increase in the consumer price index was mainly driven by the pick-up in vehicle fuel and tradables inflation. Measures capturing underlying inflation developments remained within a range of 2%-3%.

According to the CSO's preliminary release excluding the components of GDP, Hungary's gross domestic product grew by 1.4% in 2011 Q3, by 1.8% in the first three quarters of the year relative the same period of 2010 and by 0.5% relative to the previous quarter. The outturn for GDP was more favourable than analysts had expected, but weaker than in the September projection.

Industrial production picked up in September, as output grew by 2.1% relative to August and by 3.0% relative to the same period of the previous year. Although production rose in each successive month of the quarter, the quarter-on-quarter increase was only 0.4%, driven solely by rising manufacturing exports.

The volume of Hungarian exports increased, accompanied by a slowdown in the rate of decline in imports. Foreign trade in goods once again registered a substantial surplus in September. Consequently, net trade continued to be the main driver of GDP growth in 2011 Q3. However, the forward-looking indicators are consistent with a slowdown in global economic activity. Hungary's terms of trade continued to fall in August, explained by a deterioration of the terms of trade in the machinery industry, in addition to adverse movements in the price of energy.

After adjusting for working-day variations, the volume of retail sales (excluding sales of motor vehicles and components) rose by 0.3% in September. The total volume of retail sales, which is more closely correlated with consumption expenditure, fell by 0.7% relative to the same period of the previous year. According to the Bank's indicators measuring month-on-month changes, the volume of retail sales remained flat in September. In contrast to the projection in the September *Quarterly Report on Inflation*, the latest evidence does not point to any increase in household consumption expenditure. Consumption expenditure is likely to fall slightly for the rest of the year, due to the weakening in economic activity and the appreciation of the Swiss franc.

The quickening pace of private-sector earnings growth in the early part of the year slowed to a halt in Q3. The number of full-time employees in the private sector remained unchanged. Moreover, growth in the number of employees, which also includes part-time workers, slowed. Companies increasingly used more flexible patterns of employment. Consequently, growth was only seen in the numbers of part-time workers and temporary agency workers. The number of employees in the total economy increased by 40,000 relative to the final quarter of the previous year.

Financial market developments

Investor sentiment in international financial markets has deteriorated steadily in recent weeks. The escalation of the euro-area debt crisis, the deteriorating liquidity and capital position of the European banking sector and uncertainty about fiscal policy and the outlook for economic activity in the US all contributed to the decline in risk appetite. Indicating the unprecedented deterioration in investor sentiment towards the euro area, demand at the auction of German ten-year government bonds was unusually low, and yields in the secondary market began to rise.

Perceptions of the risks associated with the Hungarian economy have increased sharply over the past month; throughout most of the period this increase was mainly related to adverse developments in sentiment in international financial markets. This effect was compounded by the fact that Hungarian asset prices, which tend to be more risky by international standards, responded more sensitively to the increase in investor risk aversion. The Hungarian five-year CDS premium rose above 600 basis points. The increase in risk premia was reflected in rises in yields on both forint and foreign currency-denominated government bonds. The announcement about the beginning of talks between the Government and the International Monetary Fund contributed to an only temporary and slight decline in perceptions of the risks associated with Hungarian assets. Yields rose sharply and the forint depreciated significantly after Moody's announcement that it had downgraded Hungary's sovereign debt to sub-investment grade.

The exchange rate of the forint depreciated steadily for most of the period since the Monetary Council's interest rate decision in October, reaching EUR/HUF 317. The forint weakened more than other currencies of the Central and Eastern European region, due to both global and country-specific factors. The latter mainly included Moody's announcement of Hungary's debt downgrade. In the foreign exchange market, short forint positions continued to build up. Another piece of negative news was that forward sales of foreign currency by resident corporate participants in the market did not slow down the depreciation of the forint to the extent seen in the past. The forint strengthened temporarily by some 4% to EUR/HUF 305 following the announcement by the Government that it would hold talks with the IMF. However, it again weakened to EUR/HUF 317 after the announcement of Hungary's downgrade.

Non-resident investors' demand for forint assets fell further. The sector's holdings of Hungarian government paper dropped by some HUF 66 billion in the past month. This decline mainly affected securities with less than one-year maturity. Secondary market liquidity in government bonds fell sharply, with the result that relatively small sales led to significant rises in yields. Non-residents' outstanding FX swaps involving sales of foreign currencies in the spot market may contribute to providing cover against foreign exchange risk on the rest of government securities holdings. Domestic banks' demand for foreign currency due to early repayments of foreign currency mortgages may be another factor contributing to the increase in the sector's outstanding FX swaps.

Interest rate expectations have changed materially since the Council's last interest rate-setting meeting. Expectations of an official interest rate rise increased in the past month. This was reflected mainly in FRA quotes; however, it was also reflected in developments in other interbank rates and government securities yields. One new development was the increase in three-month BUBOR rates, which rose to exceed the central bank base rate by 40 basis points. Based on FRA quotes, the market expects a total 125–150 basis point increase in official interest rates over the next three to six months.

Position of the banking sector

Outstanding lending to the corporate sector rose by HUF 30 billion in October, due mainly to an increase in short-term forint loans. However, the increase in lending is unlikely to mark a turnaround and is seen as being a one-off event. Average interest rates on existing forint loans changed little in September, while offered interest rates began to rise at the end of September and early October. Outstanding lending to the household sector declined by nearly HUF 200 billion, due to early repayments of foreign currency mortgages. On balance, net forint lending was slightly positive. In aggregate, the average APR on housing loans remained unchanged in September. By contrast, the slow, gradual increase in the APR on home equity loans since the end of 2010 continued.

The ratio of non-performing loans to total outstanding household lending increased further in Q3. Corporate loans in arrears for more than 90 days remained unchanged after rising sharply in Q2. Banks are likely to have set aside more provisions for non-performing corporate loans, due to the deteriorating outlook for activity. This increase was mainly related to non-performing project finance loans. As a result, the loan loss coverage ratio for both the total stock of loans and project finance loans increased.

At the end of September 2011, the cumulated pre-tax profits of the banking sector amounted to HUF 112 billion, reflecting a decline of HUF 65 billion compared with June 2011. There continues to be a substantial degree of asymmetry across banks in terms of profitability. The banking sector's capital adequacy ratio fell in September, as a result of sharply higher on-balance sheet losses.

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

Council members agreed that developments in inflation and the economy had been in line with the projection in the September *Quarterly Report on Inflation*. In terms of the outlook, however, the persistent weakness of the forint increased the upside risks to inflation and caused a sharp deterioration in the balance sheet position of households and the Government, with the resulting adjustment need weakening the outlook for Hungarian growth.

Members had differing views about how the depreciation of the forint would affect inflation. Some thought that the deterioration in market participants' profit prospects would force these participants to pass on the cost increases from exchange rate changes and the uncompensated minimum wage increase to consumer prices even in the near term. In terms of the effect of the weak exchange rate on consumer prices, one member was of the view that it mainly influenced

US dollar-based crude oil imports, and therefore tax-adjusted core inflation, which has a greater significance in driving inflation expectations, was likely to rise only slightly. By contrast, other members argued that, given past experience, changes in the exchange rate of the forint against the euro had a measurable effect on developments in overall CPI inflation as well as in core inflation.

There was almost unanimous agreement among Council members that the outlook for growth had deteriorated significantly since the September projection. Some members were of the view that the depreciation of the forint exchange rate in recent months might offset the disinflationary impact of weak domestic demand, and therefore there was a threat to meeting the Bank's 3% inflation target. That in turn made it necessary to tighten monetary conditions. Others, however, thought that this question could be only answered after seeing the December *Report*.

In terms of the assessment of the external risk environment, members were of the view that the euro-area debt crisis had deepened in the second half of November. They concluded that the worsening problems caused by the US fiscal deficit also contributed to the deterioration in the external risk environment, in addition to the euro-area debt crisis.

Some members noted that the depreciation of the forint exchange rate and rises in Hungarian risk premia and yields in recent weeks mainly reflected the deterioration in global investor sentiment. They reiterated the Monetary Council's earlier assessment that the recent depreciation of the forint was not consistent with the fundamentals of the Hungarian economy. Others, however, emphasised that, over and above the extremely adverse external risk environment, developments in Hungarian economic fundamentals had also contributed to the sharp increase in perceptions of the risks associated with the economy in the past two weeks. Those members thought that the increase in risks to the outlook for growth exacerbated the risks related to debt sustainability, in addition to leading to rises in yields and a depreciation of the exchange rate. All of this was reflected in a weakening of investor confidence in Hungary and the relative performance of forint-denominated assets.

Some members felt that the announcement by Moody's that it had downgraded Hungary's sovereign debt to sub-investment grade was an unexpected move, in light of the fact that it came after the Government had announced its intention to begin talks with the IMF. Several members welcomed the Government's announcement and news that talks with the Banking Association had begun.

Assessing financial market developments over recent weeks, Council members agreed that the conditions for tightening monetary policy, as set out in the Monetary Council's press release of 15 November 2011, still prevailed, given the further increase in risk aversion in European financial markets and in perceptions of the risks associated with the Hungarian economy. All members of the Monetary Council therefore agreed on the need to tighten monetary conditions. Members also agreed that, if the outlook for inflation did not improve and risk perceptions did not decline, monetary conditions might be tightened further.

After the discussion, the Chairman invited members to vote on the proposal put to the Council. Members voted unanimously in favour of an increase of 50 basis points in the central bank base rate.

Votes cast by individual members of the Council

In favour of raising the base rate to 6.50%	**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

Péter Benő Banai, 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 20 December 2011. The minutes of that meeting will be published at 2 p.m. on 11 January 2012.