MAGYAR NEMZETI BANK

MINUTES
OF THE MONETARY COUNCIL MEETING
20 DECEMBER 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

Inflation data for the past few months did not include any significant surprises, but the outlook for domestic and global growth deteriorated markedly. The depreciation of the exchange rate since the summer has worsened the inflation outlook. This has been only partly offset by the increased disinflationary pressure caused by the further deterioration in global growth prospects. As a result of the indirect tax increase and the weaker exchange rate, domestic inflation is likely to be significantly above the target in 2012. In 2013, however, the disinflationary impact of weak domestic demand is expected to be the dominant factor, and consequently a shift to a lower inflation environment is expected.

Several factors have contributed to the deterioration in the growth outlook.

The global economic slowdown is acting as a significant drag on Hungarian growth. The problems facing the European banking sector and the fiscal austerity measures taken to ensure the sustainability of sovereign debt in a number of EU Member States are likely to lead to slower growth in Hungary's trading partner economies. Growth in the euro area – Hungary's most important export market – is expected to be around 0.5% in 2012, in line with international forecasts. Despite the slowdown in external demand, exports will continue to be the main driver of domestic GDP growth in the next two years, although the pace of export growth is expected to be slower in both 2011 and 2012.

Domestic demand is unlikely to pick up in the period ahead. The great degree of uncertainty about income prospects and the high level of instalments on household debt may lead to a significant reduction in consumption. Financial transfers may decline as a result of the Government's fiscal adjustment measures. Despite the minimum wage increase and the planned reduction in personal income tax, households' real income is likely fall next year as inflation rises. Early repayments of foreign currency loans may contribute to a pick-up in consumption only over the longer term, whereas higher instalments due to the weaker exchange rate will reduce the disposable income of households not participating in the early repayment programme.

Extremely weak lending activity is also acting as a brake on domestic growth. In addition to the deteriorating outlook for growth, the capital position of Hungarian banks has also been weakened by the euro-area debt crisis, which is adversely affecting parent banks' liquidity and capital levels. That in turn may lead to increased constraints on credit supply. Lending to households and the corporate sector are unlikely to pick up significantly over the forecast period.

Business investment is also unlikely to recover in the near term. Due to tightening credit conditions and renewed uncertainty about business conditions, weak corporate investment will only be partly offset by a few large, individual investment projects in manufacturing. While the use of EU funds may increase in the coming years, the volume of investment projects funded directly by the Government is likely to fall.

Some of the factors contributing to the deterioration in the growth outlook are likely to be permanent, with the result that the potential rate of growth of the economy is expected to fall. Economic output, however, continues to be significantly below potential. Consequently, the disinflationary impact from the real economy continues to be strong.

The Government's actions to boost employment are likely to raise the supply of labour slightly in the coming years. However, employment is unlikely to rise significantly, reflecting weak economic activity. In aggregate, the labour market will remain loose over the entire forecast horizon. Although the planned increase in the minimum wage in 2012 may lead to a temporary rise in earnings growth, cost-side price pressures are unlikely to emerge from the labour market over the coming two years.

Financial market developments

Investor sentiment in international financial markets continues to be extremely unfavourable, despite the slight improvement resulting from some positive developments during the month preceding the Monetary Council's last interest rate decision. Concerted actions by the world's leading central banks at the end of November to boost liquidity and some favourable macroeconomic data released in the US led to a significant improvement in appetite for risk. In early December, optimistic expectations related to the crisis management measures of the European Central Bank and EU contributed to sustaining optimism in the markets. The cooling in heightened expectations related to the role played by the ECB (the denial of a possible extension of its bond purchase programme) and its softer-than-expected measures led to a pronounced correction in risky asset markets. The results of the year's last EU summit did not come as a surprise – markets began to rise slightly after the announcement of crisis management measures.

In the current nervous investment environment, perceptions of the risks associated with the Hungarian economy and domestic asset prices remain sensitive to global developments. In addition, any news related to the negotiations between Hungary and the IMF/EU may have significant market-moving effects.

During the period between 29 November and 20 December, perceptions about the economy improved, in line with international trends. The five-year CDS premium fell from 621 basis points to 580 basis points, still a very high level by historical standards. At the same time, yields on five-year forint and foreign currency-denominated government bonds were again below 9%, falling by 50-60 basis points. The trend decline in non-residents' holdings of forint assets since September came to a halt, which may have been a factor contributing to the decline in yields. Auctions of government paper were associated with acceptable demand and falling yields during the period since the last interest rate decision. Cover ratios at the auctions of three-month Treasury bills and longer-term government paper were between 3-4 and 2-3, respectively.

In line with global trends, the forint appreciated by some 2.5% against the euro since the end of November, accompanied by strongly volatile movements in the exchange rate. Since end-November, non-resident participants had been taking long forint positions (and liquidating short positions) in the foreign exchange market, which fuelled the appreciation of the exchange rate.

The forint outperformed other currencies of the CEE region in recent weeks, but considering the 16% depreciation of the exchange rate since the end of September, this should be seen rather as a partial correction of its weaker performance relative to the regional average. In general, the forint exchange rate continues to exhibit amplified responses to global developments.

The sharp increase in overnight spreads reflected the serious tensions at the shortest maturities in the market of EUR/HUF FX swaps; however, those tensions eased by mid-December. Spreads continue to be elevated at maturities of three to six months.

Based on market prices, the Monetary Council is expected to raise interest rates by 50 basis points in December. Expectations are for interest rates to be raised once or perhaps twice, by 25 basis points each, at the first two policy meetings of 2012.

Position of the banking sector

Outstanding bank lending to the corporate sector fell in November, mainly due to a decline in the stock of foreign currency loans. Average interest rates on forint corporate loans barely changed in October. The sharp decline in outstanding lending to the household sector continued in November, as a result of early repayments of foreign currency mortgages. At the same time, net forint lending was slightly positive. The average APR on housing loans fell mildly at the aggregate level, whereas the slow, gradual increase in the APR on home equity loans since the end of 2010 continued. It is important to note that several banks raised interest rates on mortgage loans in October; this, however, was not yet reflected in interest rate statistics, due to the time needed for loan assessments.

The Government and the Banking Association reached an agreement on 15 December 2011. The agreement includes provisions on tightening the rules on early repayments of foreign currency mortgages, a compensation scheme, the management of non-performing foreign currency mortgages, the extension of the three-year transitional period of fixing exchange rates currently in effect and a ‘growth pact’ establishing a framework for future cooperation. In the current economic environment, it is of key importance that the Government and the Banking Association have declared their commitment to preserving the stability of the financial intermediary system, to easing the burdens on household foreign currency debtors and to promoting the recovery of the Hungarian economy. It is encouraging that the parties mentioned a predictable regulatory environment and the ability of the financial intermediary system to bear costs as necessary conditions for the system to play an active role. The agreement affects all foreign currency debtors positively; the burdens on debtors with both performing and non-performing loans will be eased to a degree, with the Government undertaking the larger part and banks the smaller part. Furthermore, the agreement will have positive macroeconomic effects via three channels. First, the burden on debtors with performing loans will fall. Consequently, their consumption may increase through an increase in their disposable income. Second, banks’ capacity to lend may increase, which may be reflected mainly in rising corporate lending. And third, *ceteris paribus*, the agreement is likely to have a positive impact on perceptions of the risks associated with the economy. Of the three channels, the first may have the strongest effect over the forecast horizon: annual consumption may be HUF 90 billion higher compared with a path without an agreement, according to the projection in the December 2011 *Quarterly Report on Inflation*.

The ratio of non-performing loans to total outstanding household lending increased further in Q3. The downward effect on profits of provisioning increased sharply during the period, due in part to the exchange rate effect and, in larger part, to early repayments of foreign currency mortgages. Higher provisioning was also reflected in the loan loss coverage ratio. Within the stock of corporate loans, those in arrears for more than 90 days remained unchanged after rising sharply in Q2. Banks set aside higher provisions for corporate loans, probably in response to the deteriorating economic outlook. This increase was mainly related to non-performing project finance loans.

In October 2011, the cumulated within-year pre-tax profits of the banking sector rose slightly. Profits continue to be highly concentrated and there remains a substantial degree of asymmetry across banks in terms of profitability. The banking sector's capital adequacy ratio fell further in October, mainly as a result of sharply higher on-balance sheet losses, but the extent of this fall was smaller than in September. Although capital adequacy continues to be adequate at the sector level, there is a considerable dispersion across banks.

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

Before taking a decision on interest rates this month, the Monetary Council discussed the December *Quarterly Report on Inflation* produced by Bank staff and reviewed the latest economic and financial developments.

Members unanimously agreed that the outlook for domestic growth had clearly worsened during the past quarter. There had been a sharp deterioration in external demand conditions, and the outlook for consumption determining domestic demand was likely to be weak as a result of the Government's contractionary measures.

That effect might be partly offset by the agreement between the Government and the Banking Association, which all members of the Council welcomed. However, views were divided concerning the possible impact on the real economy of the agreement with banks: some members felt that it would have only limited impact on lending activity in the short term, while for others the action taken to reduce the foreign currency exposure of households was unprecedented in magnitude compared to earlier periods. Consequently, the new scheme might contribute to a recovery in lending activity, which in turn might lead to an increase in household consumption.

Some members pointed out that the aggregate picture of investment activity, a key factor determining the outlook for long-term potential growth, clearly looked weaker compared to

September. One member took the view that only stabilising economic policy could help reverse the decline in investment.

Some members pointed out that the outlook for inflation had clearly weakened in the past quarter. In the latest inflation projection, the consumer price index was around 5% in 2012, reflecting the upward cost pressures from the indirect tax increases and the substantial depreciation of the forint exchange rate since the summer. Others, however, stressed the disinflationary effect of declining household demand. One member noted that tax-adjusted inflation was likely to be below the inflation target in 2012-2013.

Council members agreed that the worsening in perceptions about the Hungarian economy caused economic agents to adjust their balance sheets sharply. Some members took the view that, in addition to the problems in the global financial environment, the capital shock to the domestic banking sector and concerns about the country's longer-term growth prospects had also contributed to the increase in the domestic risk premium to extremely high levels. For other members, the protracted euro-area crisis had been the main factor contributing to the increase in Hungary's risk premium. Several members noted that although the Government's measures to ensure that next year's budget deficit was met were acting as a brake on domestic demand, they might lead to an improvement in perceptions about the Hungarian economy. Some members concluded that the structure of fiscal adjustment had a negative impact on the longer-term growth outlook.

The establishment of connections between the Government and the International Monetary Fund was unanimously welcomed by members. Analysing the international situation, members were in agreement that the European debt crisis was unlikely to be resolved soon.

Members also agreed that if perceptions about the economy and the outlook for inflation continued to worsen significantly, it might prove necessary to raise interest rates further.

After the discussion, the Chairman invited members to vote on the proposals put to the Council. Five members voted to raise the base rate by 50 basis points and two members vote to raise it by 25 basis points.

Votes cast by individual members of the Council

In favour of raising the base rate to 7.00%	**5**	Andrea Bártfai-Mager, János Cinkotai, Ferenc Karvalits, Júlia Király, András Simor
In favour of raising the base rate to 6.75%	**2**	Ferenc Gerhardt, György Kocziszky

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

Gyula Pleschinger, State Secretary of the Ministry for National Economy, was present as the Government's representative.

The Council will hold its next policy meeting on 24 January 2012. The minutes of that meeting will be published at 2 p.m. on 15 February 2012.