MINUTES

OF THE MONETARY COUNCIL MEETING

29 OCTOBER 2013

Article 3 (1) of the MNB Act (Act CXXXIX of 2013 on the Magyar Nemzeti Bank) 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

Macroeconomic developments

In September, consumer prices were 1.4% higher than a year earlier. Inflation rose by 0.1 percentage point relative to the previous month, reflecting contrasting developments. Rises in the prices of market services as well as alcohol and tobacco products were partially offset by a decline in food and fuel price inflation. Indirect tax-adjusted core inflation stood at 1.5% in the month. Measures capturing the medium-term outlook for inflation were practically unchanged relative to the previous month and have remained low since the beginning of the year. Historically low services price inflation reflects the downward impact of weak domestic demand on prices, but incoming data suggest that the partial pass-through of higher burdens resulting from the increase in companies' production costs due to government measures may have started, which is in line with the September baseline projection.

According to monthly data available for the third quarter, the slow expansion of the Hungarian economy continued. In August, industrial output fell relative to a year earlier, but rose slightly on the previous month. As seen in the first half of the year, there were once again sharply contrasting trends behind developments in total industrial sales: exports increased and domestic sales declined. The forward-looking indicators point to a gradual improvement in the outlook for the coming months. The trade balance improved slightly again in August, associated with an increase in goods trade. As a result, the trade surplus increased for two consecutive months, following the decline in the second quarter. The annual growth rates of both exports and imports rose slightly.

In August, the performance of construction rose sharply, by 14.6% relative to a year earlier. The monthly increase also reflected a base effect, in addition to the improvement in underlying economic performance. Production volumes of both buildings and other structures rose significantly, and there was a marked increase in the stock of existing contracts in August. The volume of retail sales rose by 1.5% in the month relative to a year earlier. The monthly trend indicators signal a steady increase in retail trade in 2013.

Gross average earnings in the private sector rose 3.8% in August relative to a year earlier. Earnings growth slowed both in manufacturing and market services. Consequently, the sharp acceleration in the index in July may have been a one-off increase. Overall, private sector earnings growth was moderate in the first eight months of the year, with the cumulative increase in market services in the first eight months being around zero, suggesting that wage adjustment continued.

Financial market developments

Since the September interest rate decision, sentiment in global financial markets has been driven mainly by the stalemate in the debate over the US federal budget. As a conclusion of the tense political bargaining process, on 17 October the two political parties agreed to raise the debt ceiling for four months, and government offices restarted work after being closed for over two weeks. As the critical period threatening a technical default drew closer, global indicators of risk started to rise markedly and risky asset prices fell. Although according to the most probable scenario market participants did not expect a technical default on federal debt, yields on US Treasury bills maturing in the period between 17 October and early November spiked sharply higher. News that the rating agency Fitch, referring to uncertainty surrounding the debt ceiling, placed long-term US government debt on negative watch also contributed to tensions.

After the agreement was reached, global financial markets began to rally. The key equity indices gained 2%–3% by the end of the period after recouping losses of between 2%–3% suffered in the middle of the period. Indicators measuring global risk aversion receded to their level at the end of September, and bond spreads in euro-area periphery countries narrowed further. The US dollar depreciated by 1%–2% against other developed country currencies, as several decision makers, citing the fiscal uncertainty and the adverse impact on growth of the partial shutdown of the US federal government, spoke about the possibility that the Fed would taper its asset purchase programme later than previously expected.

Overall positive macroeconomic data released in China and the euro area as well as slightly weaker-than-expected US unemployment data, which confirmed the latest consensus view of analysts and the market that the Federal Reserve could start to phase out quantitative easing in March 2014, also contributed to the increase in risky asset prices. Positive surprises on the profitability data published so far during the quarterly reporting season also contributed to the improvement in investor sentiment.

In the absence of important country-specific news or events, movements in domestic financial markets were driven mainly by global factors, and therefore Hungarian and regional asset prices moved together. However, fiscal uncertainty in the US had only a limited impact, with domestic risk indicators generally improving. Since the Council's last interest rate decision, the forint has appreciated steadily against the euro by nearly 2%, from EUR/HUF 300 on 25 September to levels close to 292. Currencies of the region appreciated by 0.8% in the period. As the forint appreciated, measures of the negative skew of the implied distribution of expectations also fell.

Yields in the forint-denominated government securities market also fell steadily. Benchmark yields declined by 25–35 basis points over the entire period. Non-residents increased their holdings of government paper by nearly HUF 75 billion. The five-year CDS spread, one of the indicators of perceptions about the economy, fell by around 18 basis points to 263 basis points; and the spread on the five-year dollar-denominated bond declined by about the same amount.

Position of the banking sector

The negative value for the MNB's Financial Conditions Index for the second quarter of 2013 suggests that financial conditions continued to act as a drag on economic growth. Following a deterioration in the first quarter, there was a slight improvement in the second quarter, but the index nevertheless remained in negative territory.

In September, outstanding bank lending to the corporate sector rose by around HUF 178 billion, reflecting a decline of HUF 193 billion in foreign currency loans and an increase of HUF 371 billion in forint loans. While the shift from foreign currencies towards the forint continued as a result of the Funding for Growth Scheme (FGS), outstanding loans rose sharply. This increase was attributable to the FGS, but there was also no significant decline in forint lending outside the Scheme. The average interest rate on new large and small-value corporate loans fell further in August.

The stock of bank lending to the household sector continued to fall in September. Foreign currency loans declined by nearly HUF 40 billion and forint loans increased by HUF 10 billion, with the total stock of lending thus falling by HUF 30 billion on balance. The average interest rate on new housing loans and home equity loans continued to decline in August.

The System-Wide Financial Stress Index (SWFSI), a measure of the level of stress from the sub-markets of key importance for financial stability, remained at a low level in the past month and at a distance from the danger zone.

The Liquidity Stress Index improved significantly in September relative to the previous month, reflecting a decline in shortages and an increase in buffers. The majority of banks would be able to meet the regulatory requirement even under stress. Overall, the banking sector's liquidity position continues to be adequate. The ratio of non-performing loans to the total stock of household loans fell slightly to 17.7% in the second quarter. The profit-reducing impact of provisioning fell by less than a tenth of one percentage point to 2.7%, and loan loss coverage increased to over 50%. Within corporate loans, the ratio of borrowers with payments overdue by 90 days or more rose to 20%. In contrast to the previous three quarters, the portfolio deterioration component was significant, and slower cleaning was unable to offset this. The profit-reducing impact of provisioning remained high, at the 3.3% level recorded at the end of March, which was enough to maintain loan loss coverage at over 55%.

At the end of September, the sector's cumulative pre-tax profits amounted to HUF 71 billion, which was significantly higher than the profit of only HUF 6 billion recorded a year earlier, but was still low compared to previous years. In large part, this reflected the results of one bank, which recorded pre-tax profits of HUF 133 billion. Four of the large banks posted losses. The twelve-month rolling ROE stood at -0.9%.

The average capital adequacy ratio fell slightly, amounting to 16.6% at the end of August. The distribution of capital adequacy continued to be asymmetric. The Solvency Stress Index, which was calculated for a stress scenario beginning in the second quarter of 2013 over a two-year horizon, indicated a lower value relative to the previous period.

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

In the Council's judgement, the Hungarian economy was likely to expand gradually this year, followed by a further pick-up in growth next year. The level of output remained below potential, and unemployment exceeded its long-term level determined by structural factors. Looking ahead, the Council expected external economic activity to strengthen and weak domestic demand conditions to persist. As a result, inflationary pressures in the economy were likely to remain subdued in the medium term.

Data for September suggested that inflationary pressures remained low. Recent movements in the consumer prices index also reflected temporary effects. The Bank's measures of underlying inflation capturing the medium-term outlook had remained broadly unchanged relative to previous months. The low rate of underlying inflation since the beginning of the year reflected the disinflationary impact of weak domestic demand. Subdued wage dynamics suggested that companies were adjusting to higher production costs mainly through the labour market, and therefore the pass-through into consumer prices was likely to be limited and gradual. The low inflation environment might help anchor inflation expectations. In the Council's judgement, therefore, inflationary pressures were likely to remain moderate, close to the target over the medium term as the temporary effects waned. In the current environment, monetary policy could contribute to meeting the inflation target over the medium term by maintaining accommodative monetary conditions.

Economic growth was likely to improve gradually in the coming quarters, supported by both exports and domestic demand components. The improvement in domestic demand was likely to be gradual, reflecting ongoing deleveraging and the cautious behaviour of households. Export growth was expected to continue in line with the rate of growth of external demand, which was projected to pick up markedly starting from the end of this year.

Perceptions of the risks associated with the Hungarian economy had improved over the past month. Uncertainties about the possible moderation of the pace of asset purchases by the Fed and about the US budget agreement had led to volatility in global financial markets. However, these concerns had diminished towards the end of the period. In the Council's judgement, changes in sentiment in global financial markets continued to pose a risk, which in turn called for maintaining a cautious approach to policy.

In the Council's judgement, there remained a significant degree of unused capacity in the economy, and inflationary pressures were likely to remain moderate for a prolonged period. Inflation was expected to remain around the target over the forecast period, providing scope to ease monetary policy further. Global financial markets had stabilised following a period of increased volatility. A sustained and marked shift in perceptions of the risks associated with the Hungarian economy might influence the room for manoeuvre in monetary policy.

In light of the above discussion, Council members agreed that recent developments in inflation and the real economy were consistent with a further easing of monetary conditions. However, decision-makers' views were divided over the extent of easing. One member noted that although sentiment in global financial markets had improved and had been supportive overall, a lasting solution of the external problems leading to increased market volatility over recent months had not yet been found. In view of the relatively high level of non-residents' government securities holdings, this might call for a more cautious reduction in the base rate than earlier. However, other members were of the view that no information was available about a possible change in the global market environment, which would make it necessary to change the current cautious pace of policy easing warranted by the outlook for domestic inflation and real economic developments.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Eight members voted in favour of a 20 basis point reduction and one member voted for a 10 basis point reduction. In the Council's judgement, considering the outlook for inflation and the real economy and taking into account perceptions of the risks associated with the economy, further cautious easing of policy might follow.

Votes cast by individual members of the Council

In favour of reducing the base rate to 3.40%	**8**	Ádám Balog, Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, Csaba Kandrács, György Kocziszky, György Matolcsy, László Windisch
In favour of reducing the base rate to 3.50%	**1**	Gyula Pleschinger

The following members of the Council were present at the meeting:

Ádám Balog
Andrea Bártfai-Mager

János Cinkotai
Ferenc Gerhardt
Csaba Kandrács
György Kocziszky
György Matolcsy
Gyula Pleschinger
László Windisch

The Council will hold its next policy meeting on 26 November 2013. The minutes of that meeting will be published at 2 p.m. on 4 December 2013.