MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

26 FEBRUARY 2013

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

Macroeconomic developments

In January 2013, inflation declined sharply, with both the consumer price index and core inflation falling to 3.7%. The moderation in inflation reflected the effect of the VAT increase in January 2012 dropping out of the twelve-month comparison and easing in underlying inflation. Measures capturing the medium-term outlook for inflation (i.e. inflation of demand-sensitive and sticky price items) fell to around 1.5%. Recent movements in measures of underlying inflation, the stagnation of processed food prices and the decline in the annual tax-adjusted index of services prices to a historical low reflect strong downward pressure on prices from subdued domestic demand. In February, inflation is set to fall further in response to the positive impact on the consumer price index of the reduction in housing costs.

According to preliminary data, Hungary’s gross domestic product contracted by 2.7% in the fourth quarter of 2012 relative to the same period a year earlier. The data for the year as a whole was consistent with a decline of 1.7%. The preliminary GDP figure was worse than analysts’ expectations and the projection for the path of GDP in the Bank’s December *Quarterly Report on Inflation*. Industrial production declined sharply, reflecting the slowdown in global economic activity and one-off factors. The contribution of agriculture to economic performance was negative throughout the year. Although fourth-quarter expenditure side data are not yet available, short-term indicators of economic activity suggest that the weaker-than-expected performance may have been related in large part to domestic demand, in addition to weak exports.

The performance of industry in the fourth quarter of 2012 may have contributed strongly to the larger decline in economic performance than expected by the Bank. Industrial production fell by 7.6% in December 2012 relative to the same period of the previous year. The decline seen in recent months continued across a wide range of sectors. New export orders fell back in December following the sharp increase in November. The trade surplus narrowed substantially, accompanied by a slight increase in exports and strong growth in imports. Confidence and business survey indicators in Europe point to an improvement in the position of the export sector in the first half of 2013.

In December, the total volume of retail sales was down 2.1% on the same month a year earlier. The real net wage bill, one of the most important factors influencing household consumption, continued to decline in a year-on-year comparison. The largest fall was seen in sales of consumer durables, consistent with the weakness in lending, subdued housing market activity and deteriorating income prospects. The available data pose a downside risk to the Bank’s projection for consumption growth in the fourth quarter of the year.

In December, gross average earnings grew by 4.9% in the whole economy and by 8.3% in the private sector relative to a year previously. The index of private sector earnings growth slowed following the sharp rise at the start of the year. Average bonuses fell slightly in 2012 relative to

2011. The alternative wage inflation index, based on regular pay, indicated a slowdown in underlying wage growth in 2012. Overall, developments in the private sector wage index in 2012 were largely in line with the Bank's expectations; data for early 2013 will provide important guidance on underlying wage developments.

Financial market developments

Investor sentiment in international financial markets has remained very supportive since the Monetary Council's last interest rate decision. A number of risk indicators improved to historical levels in February; however, the deterioration in sentiment towards the end of the month caused most of the indicators to drop back to levels seen at the end of January. Macroeconomic data released in Europe and the US last month masked a growing divergence between data on economic activity and forward-looking sentiment indicators recently: while data on economic growth in Europe and the US were disappointing, purchasing manager indices, business sentiment indices and household confidence indices improved somewhat.

Closely related to the euro-area crisis, concerns over political stability in Spain and Italy intensified, which temporarily led to a slight deterioration in market indicators for the euro area. During the period as a whole, Italian yields rose slightly and Spanish yields remained around their level at the end of January. Market analysts believe that weak data on growth and favourable inflation outcomes for emerging Europe point to further monetary policy easing in the region. The latest data releases may lead to a continuation of the easing cycle in Poland and an increase in the central bank's willingness to intervene in the Czech Republic.

Perceptions of the risks associated with the Hungarian economy changed little over the period. While movements in the forint exchange rate and the shift in the yield curve suggested an improvement in sentiment in the past month, the rise in the country's CDS spread reflected a slight deterioration in risk perceptions. The forint exchange rate strengthened gradually. Yields moved lower by around 30 basis points along the entire yield curve. As a result, benchmark yields at maturities below one year stood slightly above 5% and those at longer maturities at just over 6%. FX swap spreads fell to historical lows at every maturity, associated with liquid market conditions. By contrast, the five-year CDS spread rose slightly, mainly suggesting a deterioration in line with regional developments.

Market reaction to the issue of USD 3.25 billion in foreign currency bonds in February was favourable. Yields on Hungarian five and ten-year government bonds (4.2% and 5.43%, respectively) imply spreads of 335 basis points and 345 basis points over equivalent US government bonds. Although those levels are lower than expectations, they are relatively high compared with other countries of the region, similarly to other indicators of risk. Analysts say near-term financing risks have diminished with the completion of a major part of the foreign currency bond issuance programme, and therefore pressure on the forint government bond market may ease as well.

The publication of growth and inflation data during the month led to heightened expectations that the Monetary Council would reduce interest rate in the near term. In addition, the expected interest rate path priced into market rates shifted down, with its bottom falling to around 4.4% during the last months of the year. Increased expectations of a lower interest rate path were also reflected in market prices and analysts' forecasts.

Position of the banking sector

Outstanding bank lending to the corporate sector fell in January 2013. The slight decline in the stock of lending was related to an increase in foreign currency loans and a slightly larger drop in forint loans. Average interest rates on forint corporate loans continued to fall in the final month of the year. The average interest rate on new loans was 30–40 basis points lower than in the previous month. The total decline in the average interest rate amounted to 1.0%–1.5% in the period between the end of August and the end of December.

The stock of lending to households was also down in January. The decline was mainly accounted for by a drop in foreign currency loans, while the stock of forint loans remained broadly unchanged. Based on the December data, new bank lending to households continued to be low. The average interest rate on housing loans rose in December, whereas the average interest rate on home equity loans fell further, with the January preliminary data suggesting that the trend of lending will remain downwards.

The behaviour of the Hungarian banking sector was less procyclical than previously. The stress level of domestic financial markets has barely changed since mid-November, remaining at historically low levels. The surplus of banks with liquidity buffers rose further from its previous high levels. The capital position of the banking sector is stable. Looking forward, however, the maintenance of the bank levy and continued weak profitability pose a risk. Withdrawals of funds, the large stock of non-performing loans, the potentially insufficient coverage for loans as well as low profitability represent key risks to the operation of the domestic banking sector, which in turn may lead to a further cut-back in lending.

According to preliminary January data, the stock of external funds of the seven largest Hungarian banks continued to fall. Unfavourably, the decline mainly affected funds with remaining maturity of more than one year. This is mainly explained by profitability reasons, as favourable swap market spreads may encourage banks to swap their expensive on-balance sheet liabilities for off-balance sheet financing.

The ratio of non-performing loans to total lending to the household sector continued to rise in the fourth quarter of 2012, in line with the Bank's expectation. By contrast, the ratio of corporate loans in arrears of 90 days or more to the total fell significantly. According to preliminary January 2013 data, the banking sector's pre-tax profits amounted to HUF 18 billion. The overall capital adequacy ratio remained at appropriate levels across the sector, but showed asymmetry among individual banks.

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

In the Council's judgement, economic growth was likely to resume this year following last year's recession; however, external, and domestic demand factors in particular, pointed to only modest growth in the period ahead. The Council judged that there remained a degree of surplus capacity in the economy. The weakness in investment and persistently high unemployment suggested that the potential growth rate of the economy was significantly below its pre-crisis level. The Council expected weak demand conditions to persist, which the majority of members thought would ensure that inflationary pressure would remain low in the period ahead.

Inflation in January had slowed more sharply than expected. The decline was related to a wide range of goods and services. That, coupled with the marked slowdown in underlying inflation, might reflect the stronger-than-expected disinflationary impact of weak domestic demand. Council members agreed that the short-term outlook for inflation had improved significantly as a result of the lower-than-projected price increases around the start of the year and the government measures affecting the prices of items excluded from the core measure. However, the extent to which companies would be able to pass on higher production costs into prices in response to the government measures might be a source of uncertainty for the medium-term inflation outlook. The Monetary Council would therefore continue to monitor closely developments in underlying inflation. Several members concluded that the Bank's forthcoming *Quarterly Report on Inflation*, to be published in March, might provide further important guidance for the Council to make an informed judgement about the persistence of the current improvement in underlying inflation. One member pointed out that the disinflationary impact of weak demand might prove stronger than assumed, and therefore medium-term inflation risks might be lower than previously thought. Some members noted that strong disinflationary pressure reflected the weaker-than-expected actual GDP growth, rather than stronger-than-expected potential growth.

Global risk appetite had remained strong over the past month, but the contrast between improved investor sentiment in international financial markets and the modest outlook for growth in the world economy continued to pose a risk. Meanwhile, perceptions of domestic risks had remained broadly stable. In terms of the latter, one member noted that the supportive financial market environment had so far been sustained without a tangible improvement in domestic fundamentals, and therefore the Council should exercise increased caution when judging the recent favourable developments. There was agreement that the success of the foreign currency-denominated bond issue by the Government had reduced financing risks for the economy. Some members thought that cooperation with the European Commission and International Monetary Fund might contribute to a further reduction in financing costs and a sustained improvement in perceptions of the risks associated with the economy.

The Council was divided in its views on the depreciation of the forint since last August. Some members thought the benign international financial market environment, coupled with the

Government's commitment to hold the fiscal deficit low, might help reduce domestic financial asset premia. Those factors in turn might justify a cautious easing of monetary policy. Other members, however, thought that past interest rate cuts and those priced in by the market had played a distinct role in the depreciation of the forint since August and that reducing interest rates further would pose a risk in terms of meeting the inflation target in the medium term and considering households' still high open foreign currency position, and instead the Council should take a more cautious, wait-and-see policy stance. Some members noted that there was no sign yet of a substantial pick-up in domestic consumption, investment and — due to the strong credit constraints — in lending, and therefore the lower central bank base rate was unable to provide a strong boost to growth in the current circumstances.

In the Council's judgement, the economic data becoming available in the past month suggested that subdued demand continued to exert a strong disinflationary impact on prices. For the majority of members, that made it likely that companies would have limited ability to pass on higher production costs into prices. A majority of members thought that the favourable global financial market environment might lead to a sustained fall in domestic financial asset prices. In the light of these factors, the inflation target could be met even with looser monetary conditions.

After the discussion, the Chairman invited members to vote on the proposals put to the Council. Four members voted to reduce the Bank's policy rate by 25 basis points and three members voted to maintain it. In terms of future monetary policy decisions, members agreed that the Council would only consider a further reduction in the policy rate if the medium-term outlook for inflation remained consistent with the Bank's 3% target and the improvement in financial market sentiment was sustained.

Votes cast by individual members of the Council

In favour of reducing the base rate to 5.25%	4	Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, György Kocziszky
In favour of maintaining the base rate at 5.50%	3	Ferenc Karvalits, Júlia Király, 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

The Council will hold its next policy meeting on 26 March 2013. The minutes of that meeting will be published at 2 p.m. on 10 April 2013.