MAGYAR NEMZETI BANK

MINUTES
OF THE MONETARY COUNCIL MEETING
25 JUNE 2013

Article 3 (1) of the MNB Act (Act CCVIII of 2011 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

Data on inflation and wages that have become available in recent months continue to suggest that subdued domestic demand and the loose labour market continue to exert a moderating influence on price and wage-setting. Real economic data point to a modest improvement in underlying growth.

In May, the consumer price index stood at 1.8% and core inflation at 3.3%. The annual rates of both consumer price inflation and core inflation rose by 0.1 percentage point relative to the previous month. Core inflation, adjusted for indirect taxes, stood at 1.7% in the month. As in previous months, domestic inflation has remained at historically low levels. A slight decrease in alcohol and tobacco prices partly offset the mild increases in the prices of food and tradable goods. The inflation rate of demand-sensitive products has remained at the low levels seen at the beginning of the year. Here, services price inflation may reflect the downward pressure on prices of subdued domestic demand. The rate of tradables price inflation continues to be moderate. Weak domestic demand may slow the pass-through of cost shocks into consumer prices.

The Hungarian economy grew in the first quarter of 2013 relative to the previous quarter, bouncing back from recession. This mainly reflected, on the output side, an increase in value added in agriculture and construction. On the expenditure side, net exports made a positive contribution to growth, in addition to changes in inventories. Hungary's gross domestic product fell by 0.9% in the first quarter of 2013 relative to the same period of 2012. Seasonally adjusted, the economy grew by 0.7% relative to the previous quarter. The structure of GDP was slightly different from that presented in the March issue of the *Quarterly Report on Inflation*: the picture for household consumption was more favourable and that for net exports was lower than projected.

Indicators of domestic economic activity available for the second quarter suggest a gradual improvement in underlying growth. Industrial production was 5.3% higher in April than a year earlier and the index adjusted for working days rose by 2.9%. The goods surplus also rose, reflecting rising exports and imports.

According to preliminary data, the value of retail sales, excluding automobile sales, grew by 0.7% in April 2013 relative to a year earlier. According to revised data from the CSO, the annual index, adjusted for calendar effects, rose by 2.9%. This mainly reflected an increase in vehicle fuel sales, which may suggest a stabilisation of underlying demand conditions.

According to seasonally unadjusted data, construction output grew by an annual rate of 9.8% in April 2013. The volume of existing contracts for construction was 13.5% higher than a year earlier. The increase in the sector's output may have reflected an increase in the Government's infrastructure investment projects financed from EU funds.

Labour market data that have become available in the past month reinforce the view that companies are seeking to reduce wage costs in order to restore profitability. Private sector employment fell in the first quarter relative to the previous period. The number of unemployed rose further relative to previous quarters and was at a similar level as in the same period a year earlier. The April data indicate an increase in whole-economy employment, reflecting in large part an increase in the number of public workers and in small part an increase in that of non-subsidised jobs. In April, the rate of private sector average earnings growth rose slightly relative to previous months. This reflected the more favourable industrial production data, on the one hand, and a couple of one-off effects, on the other.

Financial market developments

Sentiment in global financial markets has been volatile since the Council's last interest rate decision. There was an improvement in the second half of the month, but risk appetite weakened significantly on the days preceding the June policy decision. Uncertainty surrounding the continuation of the Fed's asset purchase programme was the main factor behind the deterioration in sentiment, but the worsening of the outlook for the global economy also had the same effect. As a result of the former, yields rose markedly in developed economies and emerging country assets were sold heavily. Consequently, government securities yields in emerging markets rose significantly, although to varying degrees. The decline in risk appetite was also reflected in falls in the leading equity indices, the sharp increase in the VIX index and the appreciation of safe haven currencies: the Japanese yen strengthened by nearly 5% and the Swiss franc by nearly 2% against the euro.

Sentiment has also deteriorated significantly and the exchange rate has been volatile since the Council's May interest rate decision. The improvement in investor sentiment in the second part of the period proved temporary, and the turbulence in financial markets at the end of the month affected domestic developments negatively.

The EUR/HUF exchange rate depreciated from 290 to levels close to 300 on several occasions during the period; however, the decline in the exchange rate was followed by a correction in each case. Movements in the forint exchange rate were similar to those in the Polish zloty and the Romanian leu. By contrast, the Czech koruna outperformed other currencies of the Central and Eastern European region, appreciating by nearly 1%. Shifts in the EUR/HUF exchange rate were mainly influenced by fluctuations in international investor sentiment. The market's expectations for the EUR/HUF exchange rate suggest that the forint may weaken compared with earlier levels.

As seen in other countries of the region, the Hungarian five-year CDS spread rose sharply during the period, then it fell in the second half of the month, before rising again. The domestic five-year CDS spread reached the 350 basis point level on the last day of the period, which clearly reflected international influences.

Benchmark yields on Hungarian government securities rose faster than those of other emerging economies, but then fell faster during the correction which began from the middle of the period. The deterioration in sentiment at the end of the month triggered a rise in benchmark yields, leading to increases of between 20 and 35 basis points at the short end and more significant increases of between 90 and 100 basis points at the longer end of the curve. Demand at the auctions of government securities was lower compared with earlier periods.

Position of the banking sector

The negative value for the MNB's Financial Conditions Index (FCI) in the first quarter of 2013 once again suggests that financial conditions continue to act as a drag on economic growth. Although there was an improvement towards the end of 2012, the depreciation of the exchange rate and the levels of interest margins on lending outweighed the positive contribution from interest rate cuts in the first quarter of 2013.

In contrast with previous months, outstanding bank lending to the corporate sector increased in May, rising by a total of HUF 25 billion. In April, average interest rates on new small-value forint loans and forint loans of over the equivalent of EUR 1 million to companies fell.

The stock of bank lending to the household sector continued to fall in May. The decline amounted to HUF 27 billion, with foreign currency loans accounting for the entire fall. By contrast, the stock of forint rose slightly. Gross lending by the banking sector amounted to HUF 25 billion in April, representing a slight increase relative to previous months. Average interest rates on new lending to the household sector continued to follow the decline in interbank interest rates.

In May, 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 the historically low levels characteristic of earlier periods. Although the value of the index was volatile, it did not approach the danger zone.

The Liquidity Stress Index remained broadly unchanged in May compared with the previous month. Banks would meet the regulatory requirements even under stress, suggesting that their liquidity position continues to be adequate.

The ratio of non-performing loans to total lending to the household sector increased significantly: 17.9% of outstanding loans were non-performing at the end of the period. In addition to the significant rise in defaults, loan loss coverage for such loans fell slightly in aggregate. In the corporate sector, the ratio of loans overdue for 90 days or more remained unchanged.

According to preliminary data, the banking sector's pre-tax profits amounted to HUF 92 billion in the first four months of 2013. This was accounted for in large part by one bank. Of the large banks, four posted losses, with only two managing to record a profit.

The capital adequacy ratio continued to be adequate at the system level, but there was heterogeneity across banks. The Solvency Stress Index, which was calculated for a stress scenario beginning in the first quarter of 2013 over a two-year horizon and published in the *Report on Financial Stability*, indicated a higher value relative to the previous period. There were several reasons for this. First, the initial capital position was worse. Second, the earnings outlook was weaker, due to last year's weak profits. Overall, the sector's additional capital needs under stress are less than HUF 70 billion, i.e. they remain manageable.

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

In the Council’s judgement, the medium-term inflation outlook remained consistent with the achievement of the inflation target. In the short term, inflation was likely to ease further, mainly driven by falls in administered prices and commodity prices, while developments in underlying inflation would continue to reflect the disinflationary impact of weak domestic demand. The inflation rate adjusted for the direct price level increasing effects of indirect taxes was expected remain below 3% over the medium term. In the longer term, the effects of government measures increasing production costs in some sectors were likely to feed through to the corporate sector. With capacity utilisation remaining low, however, the pass-through to consumer prices was likely to be gradual and partial. Looking forward, companies’ efforts to rebuild profitability, loose labour market conditions and the adjustment of inflation expectations were likely to lead to historically low earnings growth, which might contribute to the maintenance of the low inflation environment. That in turn might help to better anchor the nominal path of the real economy to the Bank’s inflation target.

Global economic activity had picked up in the first quarter of 2013, but the risk of a multispeed growth environment amidst the global recovery had increased. Following the improvement in the previous period, sentiment in international financial markets had weakened, while indicators of real economic activity had remained subdued. The major central banks had maintained or eased further monetary conditions in the past quarter, in line with the fragile economic situation and the low inflation environment. In terms of perceptions of the risks associated with the Hungarian economy, sentiment in global financial markets had been supportive for most of the past quarter, but investor uncertainty had increased recently.

In the Council’s judgement, the rate of domestic economic growth at the beginning of the year, which had been favourable in an international comparison, had also been supported by the adjustment affecting output in some sectors of the economy. However, the slow improvement in underlying growth suggested that Hungarian GDP growth might continue in the next quarters. In the short term, growth was likely to be driven by exports due to new capacity created in the automobile industry. Consequently, Hungary’s export market share might rise even as external demand remained subdued. Domestic demand was expected to stabilise this year following the decline in previous years. Household real income was likely to grow markedly this year, but the reduction in debts accumulated in previous years, tight lending conditions and precautionary motives might impede a faster recovery in consumption. The Council expected corporate investment to fall this year as the investment projects in the automobile industry were completed. With the outlook for demand improving, a tangible improvement in investment was likely to occur, which might be supported by favourable lending conditions for small and medium-sized enterprises resulting from the Funding for Growth Scheme. A material recovery in domestic demand was expected in 2014.

Hungary’s current account adjustment had been one of the most significant across European Union countries since the onset of the crisis. The external surplus of the Hungarian economy was expected to increase further in 2013, before stabilising at a high level in 2014. The country’s external liabilities and debt were likely to continue to fall as the external balance improved further, which might contribute to a reduction in Hungary's external vulnerability.

The Council expected the government deficit on an accrual basis to remain below 3 per cent of GDP both in 2013 and 2014. Gross government deficit was likely to remain on a downward path over the forecast period and fall below 78 per cent by 2014.

In the Council's judgement, the potential output of the Hungarian economy had been growing at a slow rate since the onset of the crisis, reflecting the decline in investment and the existing financing constraints. There continued to be a considerable degree of uncertainty surrounding the size of available capacity that could be brought into production. If productive capacity had been damaged to a smaller extent, then the path of potential output might be higher and the cyclical position of the economy might be wider. With a wider cyclical position, the ability of companies to pass on cost shocks into prices was more limited and the inflationary impact of cost shocks to companies was smaller, which in turn might warrant a further, substantial easing of policy.

In the Council's view, global financial markets had become more fragile recently. However, members agreed that market movements did not exclusively reflect factors specific to the Hungarian economy. Developments related to the quantitative easing programmes implemented by leading central banks were of major importance in sustaining the supportive financial market environment. The possibility that the euro-area recession would be more prolonged despite the significant efforts by European institutions might create further uncertainty. Council members agreed that a marked deterioration in the financial environment might limit the room for manoeuvre in monetary policy, and therefore the Council should continue to monitor closely international developments.

The Council judged that, based on the above considerations, the achievement of the medium-term inflation target and the condition of the real economy allowed a further cautious easing of monetary policy. In the Council's judgement, the degree of spare capacity in the economy and the global financial market environment were the two most important sources of uncertainty for monetary policy. A sustained and marked shift in perceptions of the risks associated with the Hungarian economy might influence the room for manoeuvre in monetary policy.

Some decision-makers noted that in light of the above discussion it might be justified to deliver a more detailed message than previously on the interest rate cycle in the Monetary Council's statement. Members agreed that making a stronger reference than before to the increasingly uncertain financial market environment was appropriate in the current situation.

After the discussion, the Chairman invited members to vote and the Council made a unanimous decision to reduce the central bank base rate by 25 basis points. The Council judged that as long as the outlook for inflation and the real economy justified it, interest rates could be reduced further; however, increased caution was warranted in the volatile and fast-changing global environment.

Votes cast by individual members of the Council

In favour of reducing the base rate to 4.25%	**7**	Ádám Balog, Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, György Kocziszky, György Matolcsy, Gyula Pleschinger

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

Ádám Balog
Andrea Bártfai-Mager
János Cinkotai
Ferenc Gerhardt
György Kocziszky
György Matolcsy
Gyula Pleschinger

The Council will hold its next policy meeting on 23 July 2013. The minutes of that meeting will be published at 2 p.m. on 7 August 2013.