MINUTES

OF THE MONETARY COUNCIL MEETING

27 AUGUST 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

Inflation remains at the historically low levels of the past few months. Measures providing an indicator of the medium-term outlook for inflation were unchanged relative to the previous month and have remained low since the beginning of the year. In July, the consumer price index stood at 1.8% and core inflation at 2.8%. Core inflation adjusted for indirect taxes was 1.5% in the month. The annual rate of consumer price inflation fell by 0.1 percentage point and that of core inflation by 0.2 percentage points relative to the previous month. The low outturn for core inflation reflected the effect of depressed domestic demand. Of the non-core items, the decline in the annual index of unprocessed food prices was offset by a rise in fuel price inflation. In July, the monthly change in services prices was consistent with the outturns for the same months of previous years. Historically low inflation may reflect the strong downward pressure on prices of subdued domestic demand.

According to labour market data becoming available last month, the rate of private sector earnings growth in June slowed relative to the previous month. The number of people in employment in the 15 to 74 year age bracket rose by 1.4% in the second quarter relative to a year earlier, with the number of unemployed falling by 4.9% to 10.3%.

According to preliminary data which do not contain individual components, Hungary's gross domestic product grew by 0.5% in the second quarter of 2013 relative to the same period of 2012 and by 0.1% relative to the previous quarter. Based on the available indicators, agriculture and construction were the main contributors to GDP growth in the period.

According to monthly data, domestic demand has been rising slowly, accompanied by falling net exports. According to preliminary data, both exports and imports grew by 0.9% in euro terms in the first six months of the year, with the surplus on goods trade amounting to EUR 3.7 billion in the period.

The volume of industrial production fell by 0.6% in June relative to a year previously. According to data adjusted for seasonal and working-day variations, industrial production rose by 1.2% in month-on-month terms. Consistent with this, industrial exports also rose. The total volume of orders for industrial exports was 10.5% higher than in June 2012, but the volume of new orders fell relative to the previous year.

In June, the volume of retail sales was 0.3% lower than twelve months previously. Monthly trend indicators point to a gradual increase in sales volumes in recent months. At the same time, household borrowing continues to be weak. Accompanied by ongoing deleveraging, households' consumption behaviour remains cautious.

In recent months, construction activity has been driven by the contrast between the contraction in the housing market and a pick-up in infrastructure investment. Construction output grew further in June, rising by 12.4% in a twelve-month comparison. However, completions of new dwellings fell by 22.9% in the second quarter and the number of new housing permits issued was down by 26.4%.

Financial market developments

Risks to the global economy have remained since the Council's last interest rate decision in July, and international investor sentiment has remained fragile. Sentiment improved at the beginning of the period, before changing direction towards the end of the month, as global risk appetite faded. This was also reflected in the sharp jumps in the VIX index and the JP Morgan Chase EMBI Global, two measures of developments in investor risk appetite.

The macroeconomic data released in the US at the beginning of the period were mixed. Later, an improvement in the outlook fuelled market expectations that the US Fed might begin to slow the pace of asset purchases as early as September. Data released in the euro area also showed signs of economic recovery, but the picture for emerging Europe was mixed. Favourable foreign trade and industrial production data temporarily diverted investors' attention away from concerns over economic growth in China.

The monetary policies of major central banks remained the focus of attention in August. In line with market expectations, neither the European Central Bank nor the Bank of England changed monetary conditions in the month, but they did provide forward guidance to markets, signalling that they would keep interest rates low for an extended period and maintain an accommodative monetary policy stance over the longer term.

A significant rise in yields in developed markets began from the middle of the month, taking the yield on ten-year US Treasury bonds to a two-year high of 2.9%. The decline in yields in euro-area periphery countries was slowed sharply by the increase in yields in developed markets, while yields in Central and Eastern Europe rose markedly.

Since the Monetary Council's last interest rate decision, developments in Hungarian markets have been driven by the interpretation of the press conference following the policy decision and expectations related to the Government's rescue package for foreign currency debtors, in addition to international events. Overall, movements in the market departed slightly from those in other countries of the region, mainly in terms of long-term yields as well as the exchange rate and the CDS spread. Following statements on the rescue package for foreign currency debtors, the forint underperformed relative to other currencies of the region, depreciating by 1.5%–2%. The Czech koruna appreciated slightly, while the Romanian leu and the Polish zloty depreciated marginally against the euro.

The short end of the yield curve of Hungarian government securities remained broadly unchanged in the past month, in contrast with the long end, where benchmark yields rose significantly. As a result, the yield curve steepened sharply. The increase in perceptions of the risks associated with the Hungarian economy was also reflected in CDS quotes and yields on long-term foreign currency-denominated bonds. The five-year CDS spread rose from 295 basis points at the beginning of the period to levels close to 325 basis points.

Position of the banking sector

The negative value for the MNB's Financial Conditions Index (FCI) for the second quarter of 2013 suggests that financial conditions continue 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 July, outstanding bank lending to the corporate sector fell more strongly than in the previous months, declining by a total of HUF 94 billion. Within foreign currency loans, both short and long-term loans fell, as did the stock of short-term forint loans. In June, the average interest rate on new forint corporate loans up to the equivalent of EUR 1 million fell by around 30 basis points and that on loans over the equivalent of EUR 1 million remained flat.

The stock of bank lending to the household sector continued to fall in July. The decline amounted to a total of HUF 38 billion, broadly the same as in the previous month, with foreign currency loans accounting for the larger part of the fall. The stock of forint lending increased slightly in the month. The average interest rate on new housing loans continued to follow the decline in interbank interest rates, whereas the fall in the average interest rate on home equity loans exceeded the decline in interest rates on housing loans.

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 unchanged in the month and continued to be at a distance from the danger zone.

The Liquidity Stress Index rose modestly in July relative to the previous month, reflecting a decline in buffers and an increase in shortages. Overall, the banking sector's liquidity position continues to be adequate. The combined stress test is based on the exchange rate prevailing at the end of July; consequently, the stress exchange rate assuming a 15% depreciation corresponds to an exchange rate of EUR/HUF 345.

The ratio of non-performing loans to the total stock of household loans rose slightly to 17.7% in the second quarter. However, within the stock of corporate loans, the ratio of borrowers with payments overdue by 90 days or more rose to 20%.

The sector's pre-tax profits amounted to HUF 47 billion at the end of June 2013. This was significantly higher than the HUF 11 billion profits recorded a year earlier, but continued to be lower than in previous years. In addition, there was significant heterogeneity across banks. Of the large banks, four posted losses, with only three managing to record a profit. The twelve-month rolling ROE stands at -2%.

At 16.6% at the end of June, the capital adequacy ratio remained high, while the distribution of capital adequacy continued to be asymmetric. 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. Overall, the sector's additional capital needs under stress amount to less than HUF 70 billion, and thus they remain manageable. Looking ahead, weak profitability poses a risk, mainly reflecting the bank levy, credit losses and weak bank lending activity.

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

In the Council's judgement, Hungarian economic growth was likely to recover gradually this year, but the level of output remained below its potential and unemployment exceeded its long-term level determined by structural factors. The Council expected weak demand conditions to persist, which would ensure that inflationary pressures in the economy remained muted in the medium term.

Data for July indicated that inflation remained at historically low levels. Although temporary factors had also contributed to the decline in inflation, the persistently low rate of underlying inflation measures reflected the strong downward pressure of weak domestic demand on prices. Low wage dynamics suggested that companies were adjusting to higher production costs mainly through labour costs, rather than through consumer prices, and therefore the pass-through into consumer prices was likely to be moderate. In the Council's judgement, these factors indicated that there was no significant inflationary pressure in the Hungarian economy and that risks to inflation could remain moderate over the medium term, which in turn would help anchor inflation expectations. Members agreed that in the current environment monetary policy could contribute to meeting the inflation target over the medium term by maintaining accommodative monetary conditions.

The Hungarian economy emerged from the recession this year. The improvement in domestic demand was likely to be slow and gradual, due to ongoing deleveraging and cautious behaviour by households, while activity in external markets, mainly in developed economies, was showing signs of a revival. However, there was uncertainty about future developments in external demand, due to the slowdown in growth in emerging regions of the world. A sustained pick-up in growth was likely to occur from the end of the year as demand in Hungary's export markets improved. Council members were of the view that real economic developments warranted a more accommodative policy stance.

Perceptions of the risks associated with the Hungarian economy had increased slightly in the uncertain global financial environment. In the Monetary Council's assessment, higher volatility in sentiment in financial markets continued to pose a risk, which in turn called for maintaining a cautious approach to policy. In addition, some members noted the uncertainty caused by a number of events expected in September, for example, the Government's rescue package for foreign currency debtors and announcements about the US Fed's asset purchase programme.

In the Council's judgement, the Hungarian economy was characterised by significant unused capacity, and inflationary pressures were likely to remain moderate over the medium term. Incoming data continued to suggest that weak demand exerted a strong disinflationary impact, and therefore companies had limited ability to pass on higher production costs into prices. Consequently, a more accommodative monetary policy stance would ensure that the 3% inflation target was achieved over the medium term. After some temporary stabilisation, global financial markets had become more volatile again. A sustained and marked shift in perceptions of the risks associated with the Hungarian economy might influence the room for manoeuvre in monetary policy.

Council members agreed that incoming data on inflation and the real economy provided some scope to ease monetary conditions further. However, in light of the significant reduction in interest rates so far and taking into account developments in perceptions of the risks associated with the Hungarian economy, a slower pace of policy easing was warranted. Decision-makers' views were divided over the pace of easing. Two members proposed a decidedly smaller reduction in interest rates, due to uncertainty expected in the next month. However, other members favoured a larger reduction in the base rate, albeit one slightly smaller than the previous moves, emphasising recent developments in inflation and the real economy. One member was of the view that the pace of interest rate reductions in the coming period should not exceed the pace of today's interest rate move and that this should be the maximum extent of individual interest rate cuts.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Five members voted in favour of a 20 basis point reduction and two members preferred a 10 basis point reduction. In the Council's judgement, the significant reductions in interest rates so far and the volatile conditions in financial markets might justify changing the pace or extent of policy easing in the coming months. Members agreed that it would be appropriate to send a signal to market participants about expected changes in the future conduct of interest rate policy.

Votes cast by individual members of the Council

In favour of reducing the base rate to 3.80%	**5**	Ádám Balog, Andrea Bártfai-Mager, Ferenc Gerhardt, György Kocziszky, György Matolcsy
In favour of reducing the base rate to 3.90%	**2**	János Cinkotai, 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 24 September 2013. The minutes of that meeting will be published at 2 p.m. on 9 October 2013.