MINUTES

OF THE MONETARY COUNCIL MEETING

24 SEPTEMBER 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

In August, the annual rate of inflation fell by 0.5 percentage points to 1.3% relative to the previous month. Wage and inflation data becoming available in recent months continue to suggest that subdued domestic demand and loose labour market conditions are still acting as a brake on wage and price increases. The declines in fuel prices and administered prices were the main factor contributing to the fall in the consumer price index. Core inflation adjusted for indirect taxes 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. Incoming data suggest that subdued demand is limiting the pass-through of corporate costs into consumer prices.

According to the second release, Hungary's GDP grew by 0.5% in the second quarter of 2013 relative to the same period a year earlier. Seasonally adjusted, GDP growth amounted to 0.1% relative to the previous quarter. In the second quarter of 2013, the economy continued to recover from last year's recession, mainly on account of the slow improvement in underlying domestic and external demand. On the output side, value added in agriculture and construction rose most strongly. On the expenditure side, domestic absorption rose, mainly driven by investment, and exports also increased. However, growth in imports, which may have been related to the increase in inventories, in addition to rising domestic absorption, was considerably stronger than growth in exports in the quarter. As a result, the trade surplus made a negative contribution to GDP growth.

Available indicators for the third quarter suggest that economic growth continued in the period. In July, construction output grew by 4.8% relative to a year earlier, with growth registered across a range of branches within construction. Domestic sales also increased in July, and therefore the contrasting trends of industrial sales eased somewhat. Forward-looking indicators point to a gradual improvement in the short-term outlook for the coming months.

In July, the performance of construction rose by 1.9% relative to a year earlier and fell by 1.6% relative to the previous month. Based on the number of new contracts for the construction of buildings, mainly in the private sector, the performance of construction appears to be stabilising, and the confidence indicator for the sector continues to suggest an improving outlook. In July, the volume of retail sales rose by 0.6% relative to a year earlier. The monthly trend indicators signal a gradual increase in retail trade in 2013.

Average gross earnings in the private sector grew by 4.5% in July relative to twelve months earlier. Overall, earnings growth has been moderate this year, suggesting ongoing wage adjustment.

Financial market developments

Since the August interest rate decision, movements in financial markets have mainly been driven by expectations related to the future of the Fed's asset purchase programme and the announcement that the pace of purchases would remain unchanged. Markets were also influenced by events related to the Syrian conflict. Risk appetite declined at the beginning of the month, but news that military action against Syrian was put on hold and the Fed's announcement about the continuation of its programme contrary to expectations contributed to an improvement in sentiment by the end of the month.

Macroeconomic data released in developed economies in the period were mostly favourable. The majority of US data reinforced market participants' expectations that the Fed would already reduce the pace of asset purchases at the Committee's September meeting, but the Committee decided to maintain the current pace of purchases. In the euro area, both confidence indicators and actual data were favourable. The latter suggested that the euro area had recovered from recession and outcomes for inflation were better than expected.

As in the US, monetary conditions also remained unchanged in the major developed economies. Central banks sought to strengthen their communication. However, yields continued to rise in developed economies. US ten-year government bond yields rose to 3%, and the euro-area benchmark bond yields rose above 2%. Yields rose sharply both in the region and euro-area periphery countries in the middle of the period, before declining again slightly by the end of the period.

Withdrawals of capital from emerging markets gathered momentum, although temporarily, at the beginning of the month. At the same time, currencies of countries with large current account deficits depreciated sharply. The central banks of the countries affected responded to the situation with various instruments, but not all of these delivered the expected results. Countries of Central and Eastern Europe continued to be moderately affected by capital outflows. Market pressure on emerging countries eased, following the announcement by the Fed that it would maintain the pace of asset purchases.

Since the end of August, developments in Hungarian markets have been driven by news about the Government's rescue package for foreign currency debtors and expectations about the future conduct of monetary policy. Overall, perceptions about the Hungarian economy improved more than those about other countries of the region.

Yields at the short end of the yield curve of the Hungarian government securities market fell by 30 basis points and those at the long end by 60–80 basis points. Movements in long-term government yields were fairly stable; in the middle of the period, i.e. when the Syrian conflict began to escalate, long-term yields were 20–25 basis points higher than the levels seen at the time of the previous policy decision. Demand was volatile, and yields generally fell at the auctions held in the month. Perceptions of the risks associated with the Hungarian economy improved more than those in other countries of the region. The Hungarian five-year CDS spread dropped from 325 basis points at the beginning of the period to levels close to 272 basis points.

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 continue to act as a drag on economic growth. Following deterioration in the first quarter, there was a slight improvement in the second quarter, but the index nevertheless remained in negative territory.

In August, outstanding bank lending to the corporate sector rose by a total of HUF 27 billion. This HUF 27 billion increase resulted from a decline of HUF 68 billion in foreign currency loans and a rise of HUF 95 billion in forint loans. Foreign currency loans fell by nearly the same amount at most of the large banks. In addition, there was a general increase in forint lending. In July, average interest rates on new forint corporate loans up to and over the equivalent of EUR 1 million fell. Overall, average interest rates on new forint lending have declined by about 3 percentage points over the past one year.

The stock of bank lending to the household sector continued to fall in August. Foreign currency loans accounted for the whole of the HUF 33 billion decline. The stock of forint lending remained broadly unchanged in the month. The average interest rate on new housing loans continued to follow the decline in interbank interest rates in July, 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, was unchanged in the month and remained at a distance from the danger zone.

The Liquidity Stress Index rose slightly in August relative to the previous month, reflecting an increase in buffers and a decline in shortages. 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. 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.

At the end of August 2013, the sector's pre-tax profits amounted to HUF 88 billion, which was significantly higher than the profit of HUF 44 billion recorded a year earlier, but remained lower than in previous years. In large part, this reflected the results of one bank, while of the large banks, four posted losses. The twelve-month rolling ROE stood at -1.7%.

The average capital adequacy ratio increased to 16.7% at the end of July. The distribution of capital adequacy, however, 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.

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

The Bank's measures of underlying inflation had been at historically low levels in recent months. Favourable developments in underlying inflation reflected the combined effect of subdued domestic demand, declining inflationary pressures in external markets and the gradual adjustment of inflation expectations. The reductions in regulated prices, implemented in a series of steps this year, also contributed to the development of a low inflation environment, although the effects of government measures increasing production costs in some sectors were likely to feed through to the corporate sector over the longer term. With domestic demand remaining subdued, 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 expected to lead to moderate earnings growth. These in turn might help the Bank's inflation target to better anchor the nominal path of the economy. In the Council's judgement, based on the above factors, there was no material inflationary pressure in the economy, and therefore an accommodative stance of monetary policy was warranted in order to achieve the inflation target over the medium term.

In the Council's judgement, economic growth was likely to pick up gradually in the coming quarters. Both exports and domestic demand were expected to contribute to the slow improvement in underlying growth. Exports were likely to remain the main driving force behind growth. Low inflation and wage increases for certain employee groups in the public sector were expected to boost the purchasing power of households' disposable income. Overall, demand was likely to remain below the productive capacity of the economy, and therefore the real economic environment was expected to remain disinflationary looking ahead. The negative output gap might close at the end of the forecast horizon.

The external surplus of the Hungarian economy was likely to rise further this year, reflecting a growing surplus on goods and services partly due to the improvement in the terms of trade, the expected decline in the income deficit and the increasing use of EU transfers. In 2014, however, the surplus on goods and services was unlikely to rise further, partly reflecting higher investment and imports as a result of the Funding for Growth Scheme, while the amount of EU transfers was likely to fall due to the new budget cycle. But with the external financing capacity remaining high, the external debt ratio was likely to fall further, which in turn would reduce the country's vulnerability.

In the Council's judgement, the degree and disinflationary impact of spare capacity in the economy as well as uncertainty about the global financial market environment were the two most important sources of risk to monetary policy. There were both upside and downside risks to developments in investment, and consequently to the future path of the economy's potential output. In the Council's view, the potential output of the Hungarian economy had been growing at a slow rate since the outset of the crisis, reflecting weak investment and the existing financing constraints, but the size of available capacity that could be brought into production was surrounded by a considerable degree of uncertainty. If productive capacity had been damaged to a smaller extent than estimated, then the path of potential output might shift upwards and the cyclical position of the economy might be wider.

In the Council's judgement, possible developments in the external environment, both in terms of the real economy and financial markets, might adversely affect perceptions of the risks associated with the Hungarian economy and limit the room for manoeuvre in monetary policy. Looking ahead, the recovery in investment might be faster if companies spent a greater portion of loans received under the Funding for Growth Scheme to finance additional and sustainable investment. If the decline in investment experienced during the crisis proved longer than expected, it might result in a less favourable path.

In light of the above discussion, Council members agreed that developments in inflation and the real economy both gave scope for a further easing of policy. However, decision-makers' views were divided over the extent of easing. One member noted that the slope of the yield curve of the Hungarian government securities market had risen, which that member believed might also reflect market concerns over the continuation of the easing cycle; therefore that member proposed that the extent of easing should be more cautious, taking into consideration Hungary's high external financing requirement. However, other members were of the view that developments in inflation and the real economy as well international events were consistent with easing policy by the same extent as in August, which was also underpinned by the decline in yields at the long end of the curve since the last interest rate decision, and therefore those members saw no reason to reduce the extent of easing this month.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Six 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 monetary conditions might follow.

Votes cast by individual members of the Council

In favour of reducing the base rate to 3.60%	**6**	Ádám Balog, Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, György Kocziszky, György Matolcsy
In favour of reducing the base rate to 3.70%	**1**	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 29 October 2013. The minutes of that meeting will be published at 2 p.m. on 13 November 2013.