MINUTES

OF THE MONETARY COUNCIL MEETING

25 MARCH 2014

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 present the decision-makers' assessment of current economic conditions and the factors they consider when deciding on the base rate. Until December 2013, the Monetary Council presented the information underlying its assessments as part of the abridged minutes. In order to provide more detailed information, background materials will henceforth appear as a separate publication with enhanced content under the title 'Macroeconomic and financial market developments', at the same time as the abridged minutes.

The minutes are available on the MNB's website at:
http://english.mnb.hu/Monetaris_politika/decision-making/mnben_mt_jegyzokonyv

THE COUNCIL'S ASSESSMENT OF CURRENT ECONOMIC CONDITIONS AND THE INTEREST RATE DECISION

In the Council's judgement, inflation was likely to remain below the 3 per cent target in 2014, before moving into line with the medium-term inflation target from 2015. The consumer price index had been at historically low levels in recent months. Subdued inflation in external markets, the degree of spare capacity in the economy, the fall in inflation expectations and the reductions in regulated prices, implemented in a series of steps, had contributed to the development of a low inflation environment. However, the depreciation of the forint in recent months passed through gradually into the prices of core inflation items, which in turn pointed to higher underlying inflation. Capacity utilisation was likely to rise steadily as economic activity continued to recover. Household consumption, however, which was relevant in terms of inflationary pressures from the domestic real economy, was likely to grow only slowly, and therefore the real economic environment was expected to continue to have a disinflationary impact, although to a declining extent. In addition, loose labour market conditions and the adjustment of inflation expectations also suggested that moderate wage growth was likely to continue. In turn, that would contribute to inflation moving into line with the Bank's inflation target looking forward. The low inflation environment might help the inflation target to better anchor the nominal path of the economy. Several members noted that they perceived continued downside risks to external inflation, particularly in the euro area, which might suggest that domestic consumer price inflation would be lower than the baseline projection over the period ahead.

Economic activity had picked up gradually in the past quarters, with output rising across a wide range of sectors. Looking ahead, Hungarian economic growth might continue in a more balanced pattern than previously. Rising exports were likely to play an important role as a source of growth in the coming years, supported by new production capacity in the automobile industry brought into production and the improvement in competitiveness, in addition to the recovery in economic activity abroad. Domestic demand was expected to strengthen in the coming years. Investment was likely to pick up further, facilitated by the improvement in the outlook for activity, the easing in credit constraints due to the Bank's Funding for Growth Scheme and the increasing use of EU funding. However, household consumption was likely to grow only gradually, even as disposable income increased. Propensity to save was expected to remain high, reflecting the ongoing reduction in debts accumulated during the years prior to the crisis and the slow improvement in credit conditions.

The external financing capacity of the Hungarian economy had continued to rise towards the end of 2013 and the external debt ratios had fallen significantly. The external surplus was likely to remain high in the coming years as the trade surplus stabilised at a high level, despite accelerating growth in consumption and investment. The improvement in the terms of trade and the pick-up in export growth alongside the recovery in external demand were likely to play a dominant role in this. The surplus on the transfer balance was expected to fall slightly, due to the new budget cycle of the EU, but was likely to remain above levels recorded in previous years. 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. One member noted that the real interest rate differential between forint assets and other assets had fallen, which might pose financial market risks, given the continued high interest rate premium due to Hungary's high government debt.

Global investor sentiment had been volatile in the past quarter, reflecting the Fed's decision to further reduce the pace of its asset purchases, the increased focus on the vulnerability of some emerging economies and the escalation of the conflict between Ukraine and Russia. Domestic risk premia had been little changed since publication of the December issue of the Bank's *Quarterly Report on Inflation*. The CDS spread and foreign currency bond spreads had fallen slightly, long-term yields had risen modestly and the exchange rate had depreciated amid significant volatility. Two members were of the view that the effect of further interest rate cuts working through the interest rate channel was weakening, the impact on the exchange rate channel was not obvious and, furthermore, inflation expectations were relatively well anchored, and therefore there was limited scope for further policy easing. One of those members thought that the excessively low base rate might trigger a massive outflow of capital, which might pose financial stability risks. The volatility of the major risk indicators had increased relative to previous quarters. Nevertheless, members agreed that Hungary's position was fundamentally strong compared with other emerging market economies. The country's persistently high external financing capacity and the resulting decline in external debt were reducing its vulnerability. One member noted that, based on the decline in and the expected path of inflation, Hungarian assets might remain attractive in terms of the forward-looking interest rate compared with other countries of the region. Another member noted that the euro area was facing the risk of deflation, which might have a significant influence on Hungary. In the Council's judgement, a continued cautious approach to policy was warranted by uncertainty about the global financial environment.

The Monetary Council had identified three alternative scenarios around the baseline projection of the March *Report*, which might significantly influence the future conduct of monetary policy. In the alternative scenario assuming a persistently low external inflation environment and a slower-than-expected recovery in external demand, the inflation target might be achieved with looser monetary conditions than assumed in the baseline scenario. In the risk scenario assuming an unfavourable external environment and higher investor risk aversion, inflation moved in line with price stability in the medium term under tighter monetary conditions than implied by the baseline projection. A third scenario, assuming a pick-up in domestic employment and consumption, and consequently weaker domestic disinflationary pressures, also implied a tighter monetary policy stance.

After reviewing the projection in the March *Report*, the Council judged that there remained a degree of unused capacity in the economy and that inflation was likely to move into line with the target in the medium term. The negative output gap was expected to close gradually at the monetary policy horizon, and therefore the disinflationary impact of the real economy was likely to wane looking forward.

A majority of Council members judged that there remained some scope for a cautious reduction in interest rates in the context of heightened uncertainty in global financial markets; however, a smaller reduction in interest rates than previously was warranted by the increase in uncertainty. They concluded that, with the current reduction, the base rate had fallen very close to a level which ensured the medium-term achievement of price stability and a corresponding degree of support for the economy. Should conditions in global financial markets deteriorate significantly, the Council would see no scope for continuing the easing cycle.

After the discussion, the Chairman invited members to vote on the propositions. Seven members voted in favour of a 10 basis point reduction and two members voted for maintaining the base rate. Several members noted that the 10 basis point reduction could convey a positive message, as it fitted well with the Council's previous communications and could strengthen its credibility through cautious reductions reaching the end of the easing cycle, as had been signalled previously by the Council. A majority of members agreed that the Council should clearly signal in its press release that the easing cycle would end soon. One decision-maker proposed to send a signal that, with the current 10 basis point reduction, the easing cycle had ended, which would accompany the *Report* projection. Two members were of the view that the easing cycle had already come to an end and the current level of the base rate ensured the medium-term achievement of the inflation target and the necessary support for the economy required by meeting the target. They felt that a further reduction in the base rate would pose risks, while its positive impact would be limited.

The majority of members judged that, with the significant reduction in interest rates so far, considering changes in perceptions of the risks associated with the economy and based on currently available information, the base rate had fallen very close to a level which ensured the medium-term achievement of price stability and a corresponding degree of support for the economy. Should conditions in global financial markets deteriorate significantly, the Council would see no scope for continuing the easing cycle.

Votes cast by individual members of the Council

In favour of reducing the base rate to 2.60%	**7**	Ádám Balog, Andrea Bártfai-Mager, Ferenc Gerhardt, Csaba Kandrács, György Kocziszky, György Matolcsy, László Windisch
In favour of maintaining the base rate at 2.70%	**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
Csaba Kandrács
György Kocziszky
György Matolcsy
Gyula Pleschinger
László Windisch

The Council will hold its next policy meeting on 29 April 2014. The minutes of that meeting will be published at 2 p.m. on 14 May 2014.