MINUTES

OF THE MONETARY COUNCIL MEETING

16 DECEMBER 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 AND INTEREST RATE DECISION

In the Council's judgement, with the easing cycle completed, maintaining loose monetary conditions for an extended period was warranted by the medium-term achievement of the Bank's inflation target and a corresponding degree of support to the real economy. In addition to the primary goal of meeting the inflation target, the Council also took into account the condition of the real economy and incorporated financial stability considerations into its decisions.

Significant differences remained across the individual regions in terms of economic growth. The recovery in the euro-area economy was slow and fragile, while strong growth in the US was likely to continue looking ahead. Growth was slowing in the larger emerging market economies. Global inflation remained moderate, in line with the decline in commodity prices, particularly the sharp drop in crude oil prices and weak demand, and inflationary pressure in the global economy was likely to remain moderate for a sustained period looking ahead. There had been differences in the monetary policy stance of globally influential central banks in recent months; however, monetary conditions remained loose overall and, consequently, global interest rate and liquidity conditions continued to be supportive.

The Council expected inflation to be significantly below the inflation target next year and rise to levels around 3 per cent in the second half of the forecast period. In recent months, inflation had been lower than the projection in the September issue of the *Inflation Report*, mainly on account of the sharp decline in commodity prices, low food prices and weak demand. In the first half of the forecast period, domestic inflation was likely to be substantially below the target, mainly reflecting cost shocks having downside effects on inflation as well as the weak demand and inflation environment in Hungary's major trading partner countries. In the second half of the forecast period, inflation was likely to move in line with the inflation target, reflecting the recovery in activity and the increase in wage dynamics, as the effects of cost shocks faded away. Inflation expectations anchored around the target were likely to ensure that price and wage-setting would be consistent with the inflation target.

In the Council's judgement, the current level of interest rates contributed to achieve the inflation target in the medium term and ensured a corresponding degree of stimulus to the real economy, and therefore no change was warranted. Discussing the international economic environment, some members noted that the outlook for monetary policy set by major central banks, the intensification of geopolitical tensions and movements in oil prices posed both upside and downside risks. Several members argued that, although downside risks to inflation had increased somewhat, a decision to change the monetary policy stance was not warranted based on the projection in the December issue of the *Inflation Report*. Some members noted that maintaining the base rate and maintaining the Council's forward guidance in an unchanged form might help strengthen the Bank's credibility and predictability.

The recovery in the real economy had continued over the past quarter, with output rising across most sectors on an annual basis. At the forecast horizon, domestic demand was expected to make the largest contribution to growth. Subdued global activity and the slowdown in the euro area economy were likely to act as a drag on export growth in 2015; however, the contribution of net exports to growth was likely to increase in the second half of the forecast period. The extended and prolonged Funding for Growth Scheme was likely to promote corporate investment next year, but weak global economic activity abroad and lower receipts of EU funding were likely to work in the opposite direction. Households' investment activity was expected to rise gradually from its historically low level. As seen in previous quarters, the gradual improvement in employment and rising household real income due to low inflation were likely to play a key role in the recovery in household consumption. The uniformity decision by the Curia concerning household loans would effectively contribute to the reduction in existing debts. As a result, household net financial wealth was expected to increase, accelerating the deleveraging process. The conversion of foreign currency loans into forint was expected to reduce uncertainty surrounding households' future income and wealth position, thereby strengthening consumer confidence and supporting the recovery in consumption and domestic demand.

The external position of the economy had amounted to nearly 8 per cent of GDP in the second quarter of 2014. Over the coming year, the trade surplus was expected to rise despite the increase in imports driven by the pick-up in consumption and investment, reflecting the improvement in the terms of trade and, from 2016, the recovery in external demand. The surplus on the transfer account was likely to fall from its historical high as the budget cycle of European Union funding ended. As a result of the two offsetting effects, Hungary's current account surplus and external financing capacity were likely to stabilise at a high level in the coming years. Consistent with this, the country's external debt ratios, key in terms of the country's vulnerability, were likely to continue to decline. The Bank's self-financing programme, the conversion of foreign currency loans into forint and the provision of foreign currency funding by the Bank related to conversions would contribute positively to the change in gross debt.

International investor sentiment had been generally favourable in the past quarter. Global risk appetite had fallen in the middle of October, but sentiment in financial markets had begun to improve from the end of the month. The positive turnaround in sentiment reflected the release of favourable macroeconomic data in the US, the launch of the ECB's asset purchase programme, monetary easing by the Bank of Japan, the reduction in interest rates in China and the continued decline in crude oil prices. Of the domestic risk indicators, the CDS spread had been broadly unchanged over the past quarter and foreign currency bond spreads had fallen. Long-term yields on forint-denominated bonds had declined significantly in the period since publication of the September *Inflation Report*. The forint had appreciated against the euro in the past quarter, mainly due to country-specific factors. Hungary's persistently high external financing capacity and the resulting decline in external debt contributed to the reduction in its vulnerability. In the Council's judgement, a cautious approach to monetary policy was warranted due to uncertainty in the global financial environment.

Overall, downside risks to inflation had increased relative to the September *Report* projection. The Monetary Council had considered three alternative scenarios around the baseline projection in the December *Report*, which, if materialised, might influence significantly the future conduct of monetary policy. In the alternative scenario assuming persistently lower oil prices, the decline in the price of oil was mainly driven by supply-side factors. The lower inflation environment pointed in the direction of looser monetary conditions than assumed in the baseline scenario and economic growth might be stronger. The alternative scenario assuming persistently weak external demand implied downside risks to growth and inflation, and therefore looser monetary conditions ensured the achievement of the inflation target. The intensification of geopolitical tensions, associated with a decline in external demand, could lead to a sudden, sharp rise in the risk premium. As a result, exchange rate depreciation might raise inflationary pressure, and therefore a tighter monetary policy stance might ensure that the inflation target was met at the forecast horizon.

Overall, in the Council's judgement, there was a degree of unused capacity in the economy and inflationary pressures were likely to remain moderate in the medium term. The negative output gap was expected to close gradually at the monetary policy horizon. Looking ahead, therefore, the disinflationary impact of the real economy was likely to diminish.

After the discussion, the Chairman invited members to vote on the proposition put to the Council. Members voted unanimously in favour of maintaining the base rate at 2.10 per cent. The Council judged that, if the assumptions underlying the Bank's projection held, achieving the medium-term inflation target pointed in the direction of maintaining current loose monetary conditions for an extended period.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 2.10%	**8**	Ádám Balog, Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, György Kocziszky, György Matolcsy, Gyula Pleschinger, László Windisch

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

László Windisch

The Council will hold its next policy meeting on 27 January 2015. The minutes of that meeting will be published at 2 p.m. on 11 February 2015.