Macroeconomic and financial market developments

October 2015

Background material
to the abridged minutes of the
Monetary Council meeting
20 October 2015

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The background material 'Macroeconomic and financial market developments' is based on information available until 15 October 2015.

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 decisions on interest rates. Abridged minutes of the Council's rate-setting meetings are released regularly, before the next policy meeting takes place. As a summary of the analyses prepared by staff for the Monetary Council, the background material presents economic and financial market developments as well as new information which has become available since the previous meeting.

The abridged minutes and background materials to the minutes are available on the MNB's

website at:

http://www.mnb.hu/en/monetary-policy/the-monetary-council/minutes

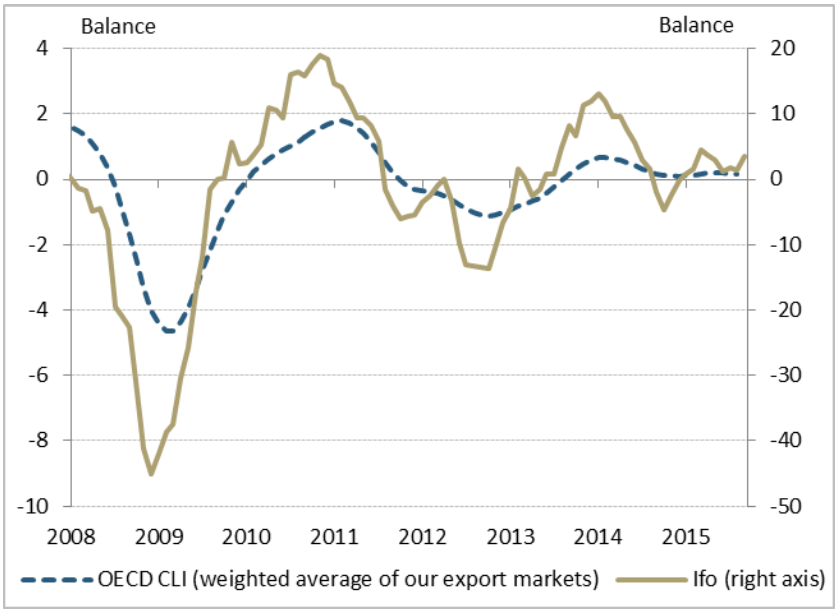
1. MACROECONOMIC DEVELOPMENTS

1.1. Global macroeconomic environment

GDP data in the second quarter of 2015 were slightly lower than expected. Based on the incoming indicators, in recent months growth in developing countries may have decelerated compared to earlier expectations. Growth remains fragile surrounded primarily by downside risks. The outlook for growth in the world's emerging regions compared to pre-crisis levels has slackened. Persisting geopolitical tensions may continue to restrain growth in developed countries through weaker demand and economic sanctions.

The euro area economy registered a quarter-on-quarter growth rate of 0.3 per cent in the second quarter of 2015. The monthly production data received show a moderate upturn in the economic activity of the region. Although the forward-looking indicators of economic activity imply moderately improving performance, the protracted management of the Greek situation may affect the economic performance of the euro area negatively. In addition, the tense geopolitical situation may also have a negative impact: increasing uncertainty and bilateral economic sanctions may restrain economic activity. These factors may have contributed to the fact that economic expansion continued at a more moderate rate than in previous quarters. Economic growth in Germany, Hungary's most important export partner, accelerated in the second quarter, but was still moderate. Domestic demand in Germany grew further, but external market activity may have been curbed by the Russia–Ukraine conflict and the slowdown in demand in Asia. The German trade data from August signalled considerable deceleration. In addition, both industrial orders and industrial production slackened in August. Expectations concerning the German economy (Ifo) indicate a less favourable outlook than at the beginning of the year (Chart 1). Overall, the average increase in new orders in the German industry was modest in the past months.

Chart 1: Indicators of activity in Hungary's export markets

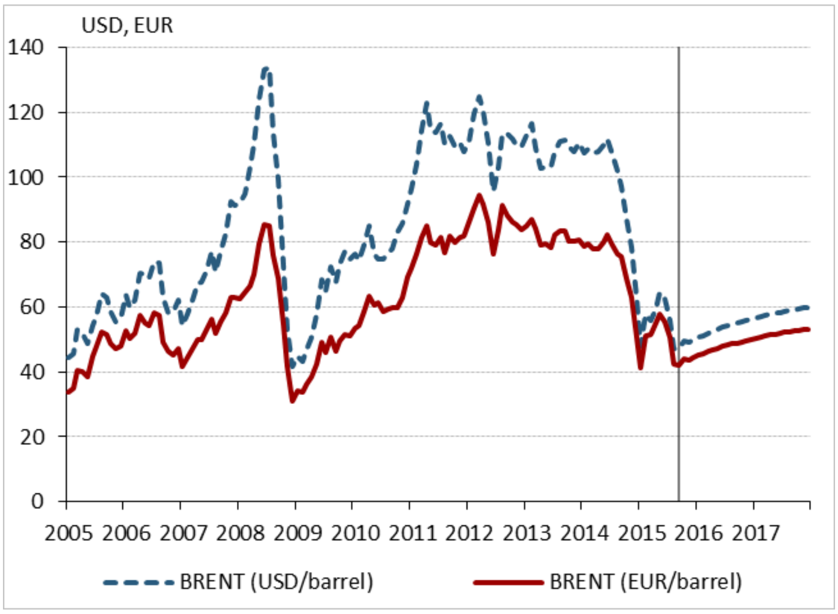


Sources: OECD, Ifo.

The performance of the region was outstanding in the second quarter of this year but, according to monthly indicators of recent months, industrial output is still fragile in the region. The negative effects of the Russia–Ukraine conflict may have had only a limited impact on growth in the CEE region so far, but looking ahead, the expected significant contraction in the Ukrainian and Russian economies may, both directly and indirectly, hinder economic growth in the region.

Inflationary pressure from the world market remains weak. The fall in commodity prices combined with weak global demand are reducing inflation. As a result, inflation rates remained below target in the world's major economies (euro area inflation stood at -0.1 per cent in September). In September, oil prices were volatile, but on the whole they have not changed significantly since the last rate-setting meeting (Chart 2; for more details, see subsection 2.1).

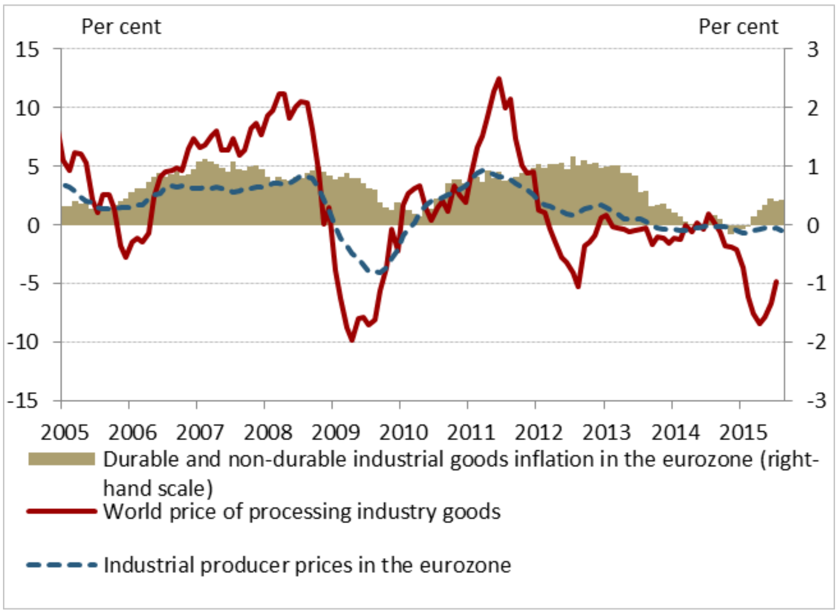
Chart 2: World market price of the Brent crude oil



Source: Bloomberg.

The world market prices of industrial commodities and unprocessed food were moderate, while the prices of manufactured goods somewhat adjusted after a considerable fall (Chart 3).

Chart 3: Industrial producer prices and tradables inflation in the euro area and world market prices of manufactured goods



Sources: Centraal Planbureau (www.cpb.nl), Eurostat, ECB.

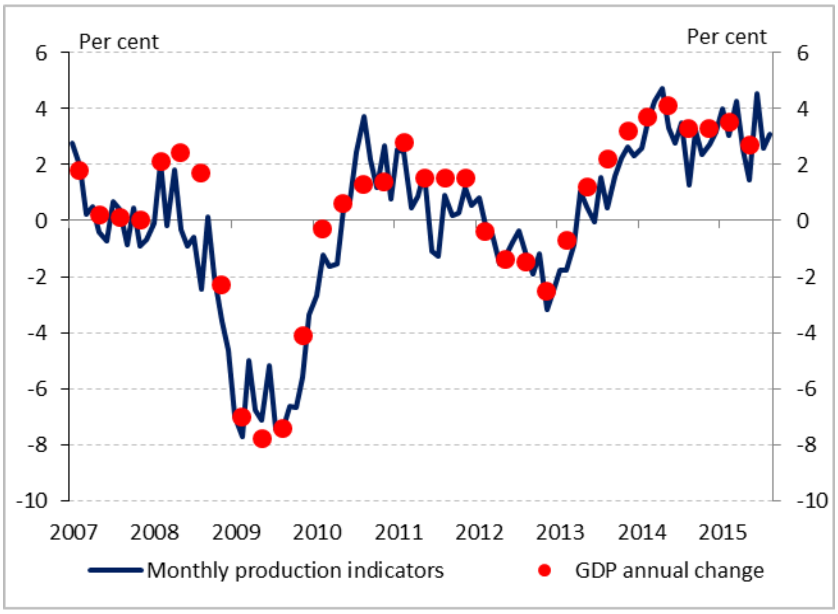
1.2. Domestic real economy developments

1.2.1. Economic growth

The Hungarian economy continued to grow in the second quarter of 2015. According to the detailed data Hungary's GDP was up 2.7 per cent year on year, with a 0.5 per cent growth recorded relative to the previous quarter.

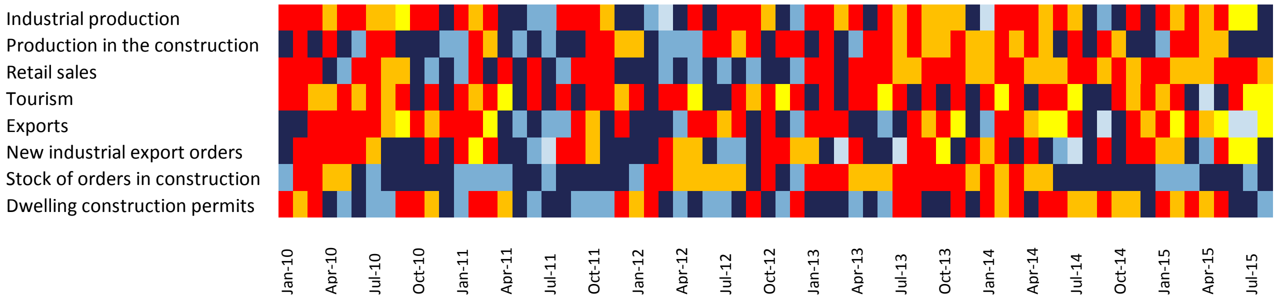
Economic growth decelerated slightly in the second quarter of this year (Chart 4). The highest year-on-year growth was observed in manufacturing and construction. Manufacturing and financial services were the main contributors to GDP growth. At the same time, economic expansion was lower than in the previous quarters, which may primarily be attributable to the decline in the performance of agriculture, as due to the high base of last year's favourable harvest results the contribution of agriculture to growth was negative in the second quarter as well.

Chart 4: Changes in monthly production indicators and GDP*



* Weighted average of monthly production indicators (industrial output, construction output and retail sales). The weights are derived from regression explaining GDP growth. Source: MNB calculations based on HCSO data.

*Chart 5: Growth heat map**



* The growth heat map shows the three-month moving averages of the seasonally adjusted monthly growth rates of the most important monthly indicators of activity, using the following colour code: red = grows above the five-year average, at an accelerating rate; orange = grows above the average, at a slowing rate; yellow = grows below the average, at an accelerating rate; light blue = grows below the average, at a slowing rate; blue = falls at a slowing rate; dark blue = falls at an accelerating rate. Source: MNB calculations based on HCSO data.

In August 2015, **industrial output rose by 6.2 per cent year on year**. Seasonally adjusted production, excluding the working day effect was **2.0 per cent down compared to the previous month.** In August, **the performance of manufacturing subsectors showed a mixed picture**. Of the major subsectors, the output of machinery, chemical and metal industry declined, while food production and manufacture of electronic and optical products have not changed significantly compared to the previous month. Both domestic and export industrial sales increased year on year. Overall, based on the forward-looking indicators, the gradual pick-up in the euro area may continue in the coming months, with possible support from low oil prices and the loose monetary policy of the ECB. In the medium run global economic activity, and particularly the signs implying the deceleration of the emerging countries, carry a downside risk with regard to the output of domestic industry.

Expressed in euro terms, in August the value of both **exports and imports increased by 6.2 per cent year on year.** Balance of trade surplus increased by EUR 25 million, reaching EUR 459 million, which exceeds the value registered last year. Export prices slightly increased, while import prices stagnated, resulting in a less dynamic improvement in the terms of trade in July.

In August 2015, **the volume of construction output decreased by 6.1 per cent year on year**, while the seasonally and working day adjusted figure **fell by 3.5 per cent compared to the previous month**. The performance of the sector is expected to be moderate in the second half of 2015, which may be attributable both to the steady decline lasting for more than one year in the book of contracts and last year's high base. Approaching the end of the 2007–2013 EU programming period, infrastructural projects financed from EU funds may be accomplished gradually in the course of the year.

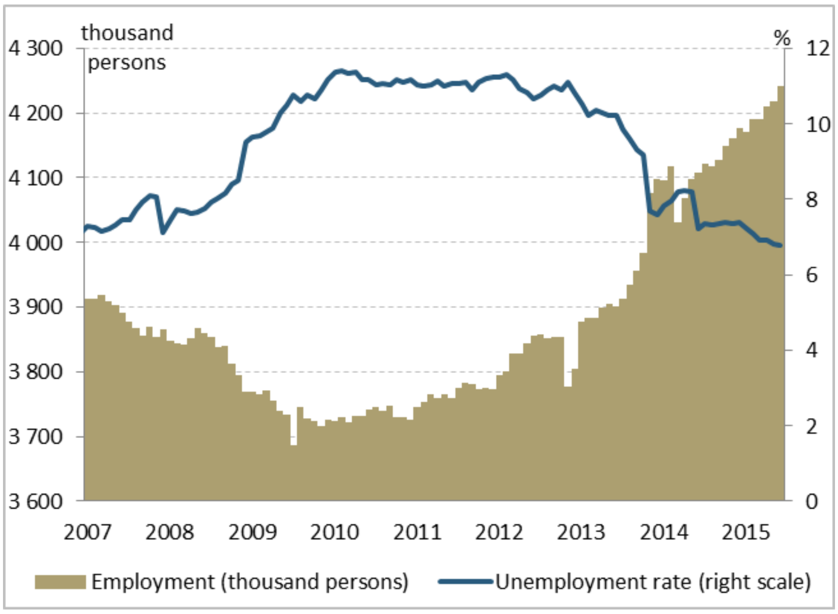
The pick-up in consumption demand observed early in the year continued in the second quarter as well. This may be explained by the improving labour market situation and by the increase in real wages as a result of low inflation, as well as by the upswing in retail sales volumes. In August, according to preliminary data, sales volumes increased by 5.6 per cent year on year, while the decrease in turnover was 0.2 per cent compared to the previous month. In August, retail sales may have increased in a wide range of products. Food sales posted a stable growth on the average of the last months, while the slackening dynamics of non-food consumer durables may be attributable to last year's high base. In accordance with the material fall in fuel prices observed in the recent period, the growth in fuel sales continued to contribute to the growth in retail sales volume. Domestic sales increased at a higher rate than the average observed in the countries of the region and in the developed European countries.

1.2.2. Employment

According to Labour Force Survey data, **the number of employees in the whole economy continued to increase in August 2015**. Employment increased, while there was no change in the unemployment rate under the increased participation rate (Chart 6).

Employment in the private sector continued to increase in the second quarter. Within the private sector the growth in employment was primarily related to market services, whereas the number of employees in the manufacturing sector did not change notably. The number of people working in the general government grew significantly, which may have been mostly attributable to the considerable extension of the fostered workers programmes.

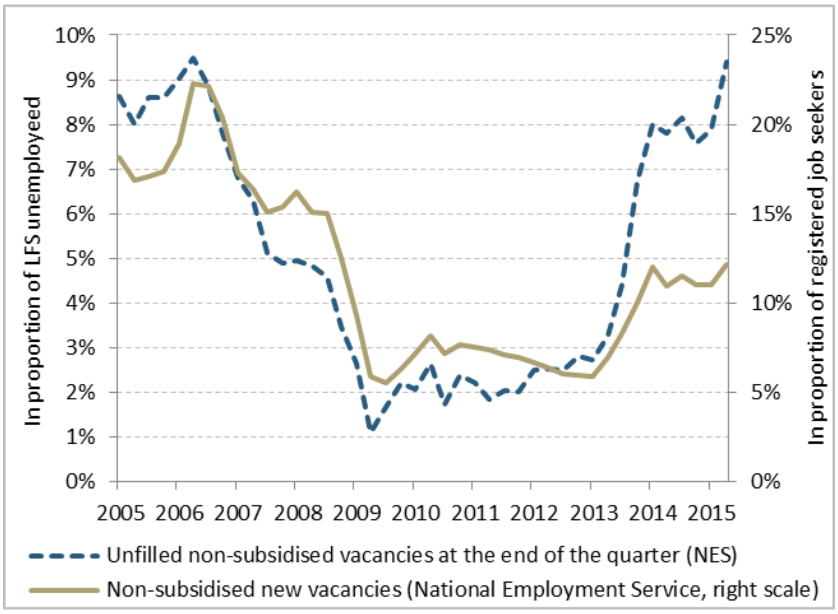
Chart 6: Number of persons employed and the unemployment rate



Source: HCSO.

In August, **the number of newly announced non-subsidised jobs increased** compared to the previous month, while **the end-of-month number of vacant, non-subsidised jobs decreased** in August. Taken together, **the labour market tightness once again increased** in the past months (Chart 7).

Chart 7: Indicators of labour market tightness



Sources: HCSO (Labour Force Survey), National Employment Service.

1.3. Inflation and wages

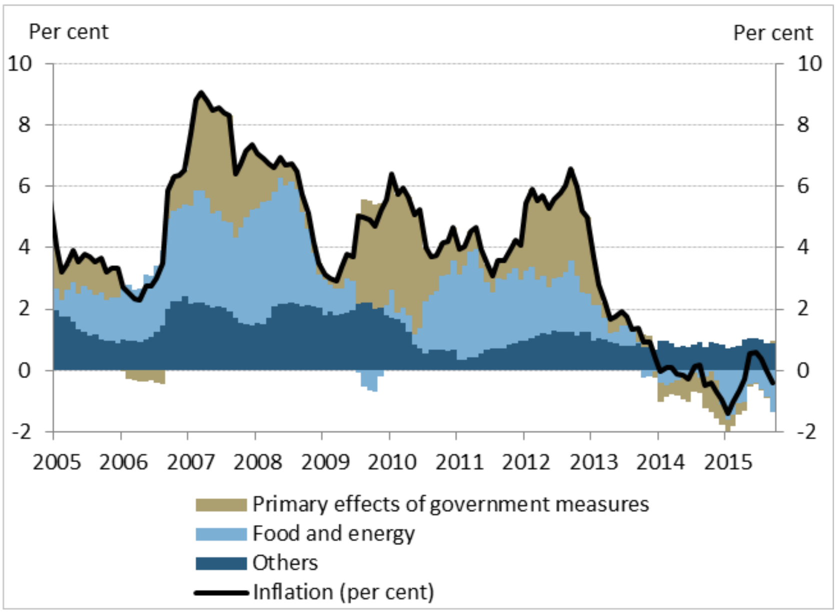
1.3.1. Wages

In July, following strengthening in the previous month, **annual wage dynamics in the private sector decelerated**; therefore, the **increase in wages can still be considered restrained**. Within the private sector the wage dynamics decelerated in the manufacturing, as well as in the market services sector.

1.3.2. Inflation developments

In September 2015, inflation was -0.4 per cent, while core inflation was 1.3 per cent and core inflation excluding indirect taxes stood at 1.1 per cent (Chart 8). The current decline in inflation was attributable to the decreasing fuel prices, while the more moderate than expected increase in core inflation is due to the fact that the price developments of the market services and processed food fell short of the expectations.

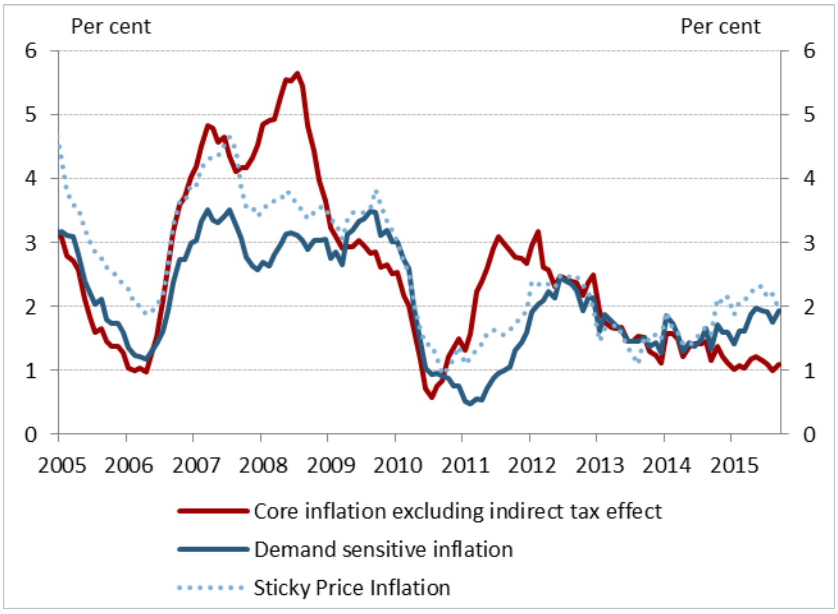
Chart 8: Decomposition of the consumer price index



Source: MNB calculations based on HCSO data.

Underlying inflation indicators continue to point to a moderate inflation environment, which may be attributable to the low level of imported inflation, low oil prices and the magnitude of unutilised capacities (Chart 9). In August 2015, agricultural producer prices fell by 3.8 per cent in annual terms. The domestic sales prices of the consumer goods sectors declined by 0.4 per cent year on year.

Chart 9: Measures of underlying inflation



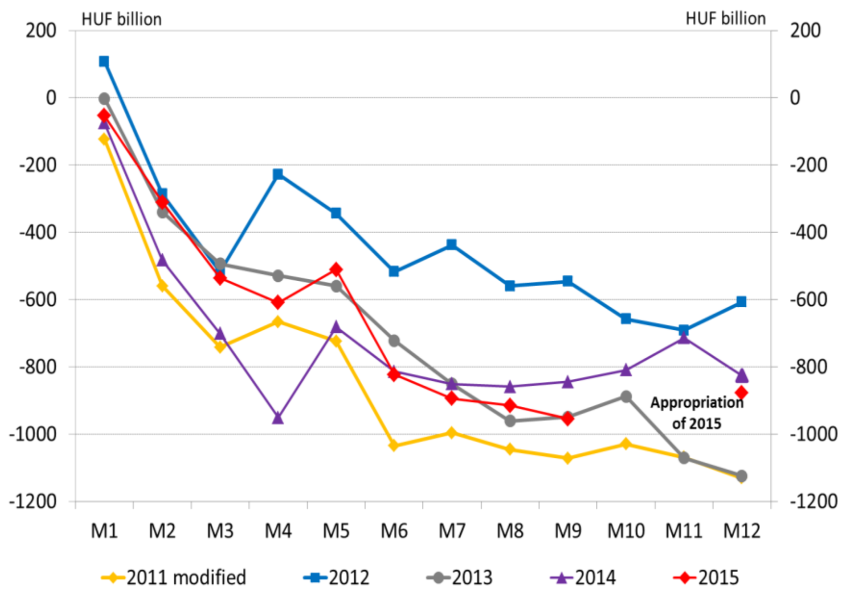
Source: MNB calculations based on HCSO data.

The data received for September were slightly below our expectations described in the September Inflation Report, which is attributable to the deviations observed in several main categories. In the coming months inflation may once again rise to the positive domain, but looking ahead it may significantly fall short of the 3 per cent target and may approximate it only by the end of the forecast horizon.

1.4. Fiscal developments

In September 2015 the central subsystem of the general government registered a deficit of HUF 40 billion, which exceeds the deficit recorded in September last year by HUF 54 billion; in addition, it also exceeds the average deficit registered in the same period of the past three years (Chart Chart *10*). Favourable changes in the underlying trends continued in September as well, but EU funding was again significantly below the usual levels of the previous years.

Chart 10: Intra-year cumulative balance of the state budget



Source: Hungarian State Treasury.

The revenues of the central subsystem in September 2015 were up by HUF 42 billion year on year. Most of the revenue surplus is attributable to higher revenues from VAT, social contribution tax and individual contributions in September. Expenditures of the central subsystem in September exceeded the 2014 base by nearly HUF 100 billion. The increase in expenditures is still mostly attributable to the growth in net expenditures of the budgetary institutions related to EU funding.

1.5. External balance

According to the August data release, the seasonally unadjusted external financing capacity is still high, but it also declined to EUR 850 million, with surpluses of nearly EUR 490 million and almost EUR 360 million in the current and capital accounts, respectively.

Financing data indicate a higher financing capacity, amounting to EUR 950 million. This financing capacity was the result of an increase in FDI inflows and a decline of EUR 1.5 billion in net external debt. The increase in foreign direct investments of almost EUR 500 million was attributable to the reinvestment of earnings. Net external debt declined by nearly EUR 1.5 million, achieved by a higher debt repayment by the banks (EUR 0.9 billion) and a lower one by the enterprises and the state. The gross external debt of the state continued to decrease due to the decline in the margin accounts and the sales of securities by the non-resident sector – the market impact of the latter may have been offset by the purchases made by the domestic banks.

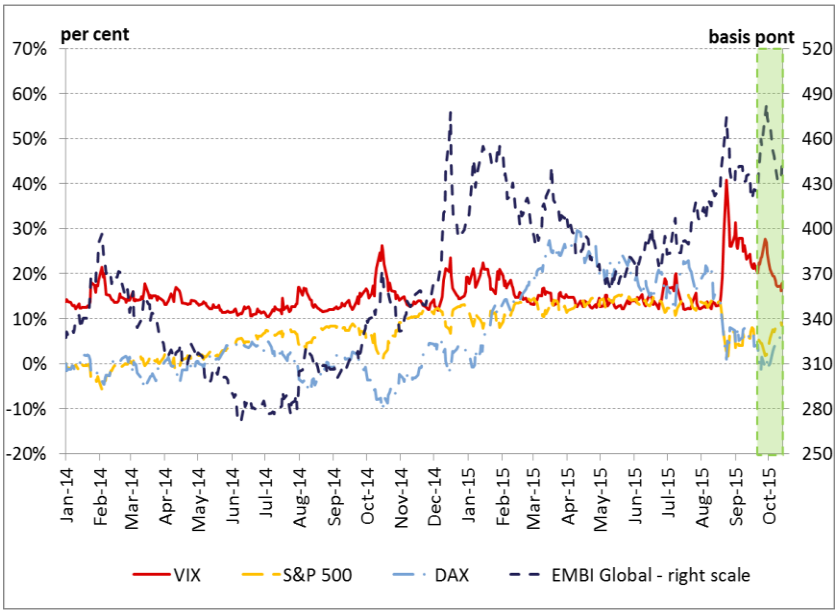
2. FINANCIAL MARKETS

2.1. International financial markets

In the period since the last interest rate decision, investor sentiments improved after the initial slight worsening. The risk indices decreased, while risky assets were typically on the rise. The developed stock market indices and the emerging market indicator accumulated a plus of 1-2 per cent and 2-3 per cent, respectively. In the commodity market, precious metal and agricultural produce prices increased, while the industrial commodity and fuel prices typically fell. The foreign exchange market was dominated by the dollar depreciation. Market sentiments were mostly driven by the expectations related to the potential interest rate increase by the Fed, and the changes in such expectations. In addition, the focus was on the deceleration of the emerging market economies, the possible extension of the ECB's quantitative easing programme, the Volkswagen scandal and the macro figures.

In parallel with the improvement in global risk appetite, most of the risk indicators declined during the month. The VIX stock exchange volatility index fell to 17-18 points from 22-27 points measured at the end of September, the euro/dollar implied volatility also fell, while the EMBI Global Emerging Markets Bond Index returned to around 440-450 basis points. There was a downward shift in the developed market long-term yields, while the long-term yield spreads of the periphery countries and the emerging markets narrowed. (Chart 11)

Chart 11: Developed market equity indices, the VIX index (left scale) and the EMBI Global Index (right scale)



Source: Bloomberg.

In the USA the picture of the economy is essentially positive (the 3.9 per cent GDP figure was a positive surprise); however, **labour market data continue to paint a somewhat contradictory picture**. On the one hand, it is favourable that unemployment is still at a low level of 5.1 per cent, and the number of those applying for unemployment benefit for the first time also stabilised below the level of 300 thousand, and even improved since last month. However, the increase in the number of non-agricultural employees (NFP) was once again a negative surprise for the markets, moreover, even the NFP figure of August was revised downward. Taken together, **based on the market pricing the anticipated date of the first interest rate increase was rather uncertain** (the chance of an interest rate hike in December is slightly below 30 per cent). The statements made by the Fed policy-makers, although they do not provide a straightforward guidance, suggest an interest rate increase this year, while the market expectations shifted to 2016; the economists' expectations are closer to the Fed's communication. Taken together, **the positive market sentiments were mainly attributable to the shift in the time of the expected interest rate increase.**

Concerns about the economic growth of China also contributed to the remaining uncertainty related to emerging markets. During the month the Chinese Manufacturing Purchasing Managers' Index fell to its 6-year low, which once again put the focus on the deceleration of the emerging countries. In addition, the **IMF further worsened its global growth expectations forecast in its World Economic Outlook** mostly with reference to the emerging markets.

In the light of the recently published euro area and German inflation data, once again being in the negative domain, the monetary policy of the European Central Bank points to easing. The expectations that **the ECB may extend its quantitative easing programme** arose already after ECB's interest rate decision in September, and have increased since then. Most of the analysts expect that the central bank will prolong the maturity of the ECB QE programme, currently scheduled to September 2016; about 40-45 per cent of the respondents also expect an acceleration in the monthly rate of the asset purchases.

Due to the diverging monetary policy stance of Fed and ECB, the EUR/USD cross rate was volatile, while in the last one month a trend-like depreciation of the dollar was observed. Commodity prices showed a mixed performance: the prices of precious metals and agricultural produce typically increased, while industrial metal and fuel prices were decreasing. Dollar depreciated against almost all currencies, while the emerging market currencies slightly appreciated.

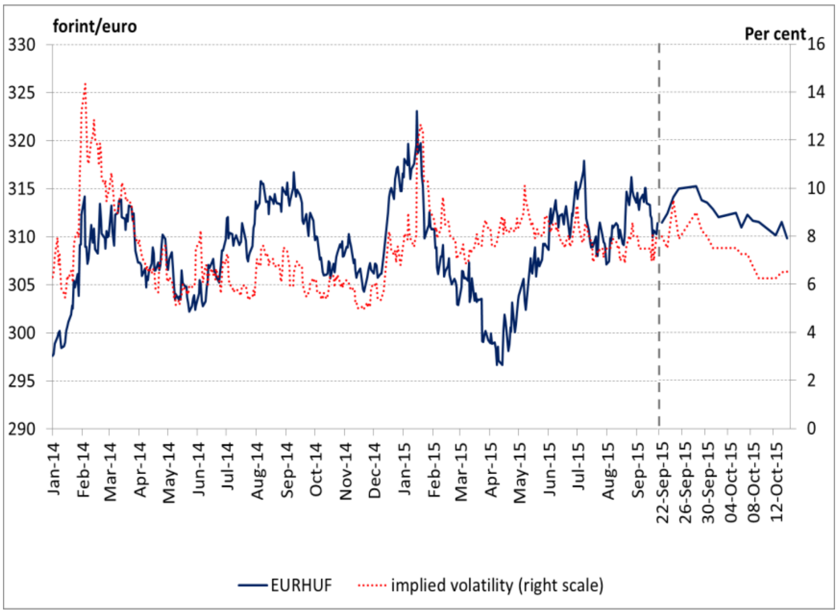
In addition to the foregoing, the focus was on the elections in Greece, ending with the victory of Syriza, and the impacts thereof, as well as on the Ukrainian loan restructuring. As regards Greece, it appears that the government is ready to implement the measures of the third Greek rescue package and regards the bank recapitalisation as one of the most important measures. In the case of Ukraine, due its failure to pay the expired bonds, Fitch downgraded the country to the restricted default category. The conditions of the loan restructuring were voted for by the qualified majority of the bond holders, with the exception of Russia.

2.2. Developments in domestic money market indicators

During the month the shift observed in the domestic market was in line with the international trends. The early days of the period the global market were dominated by concerns with regard to the global growth prospects, causing the domestic asset price also to weaken. However, from the end of September the expectations with regard to the delay in the interest rate increase by the Fed and the resulting generally increasing risk appetite dominated the trading trends. Accordingly, the gradual appreciation of the domestic assets could be observed. The MNB announcements related to pushing the interest rate corridor lower and the reform of the mandatory reserve system had no material market moving impact. Of the macro figures, the lower than expected inflation figure slightly decreased the yields in the government securities market.

The euro/forint exchange rate fluctuated in the band between 309 and 315 since the last interest rate decision (Chart 12)**.** The initial depreciation followed by a gradual appreciation was in line with the change in the international sentiment; **by the end of period the quotes fell slightly below 310.** Of the regional currencies, the Czech koruna followed a similar path as forint, with a minor swing, while Polish zloty was not able to strengthen in the favourable international environment that commenced in October, thus on the whole it depreciated by about 1 per cent.

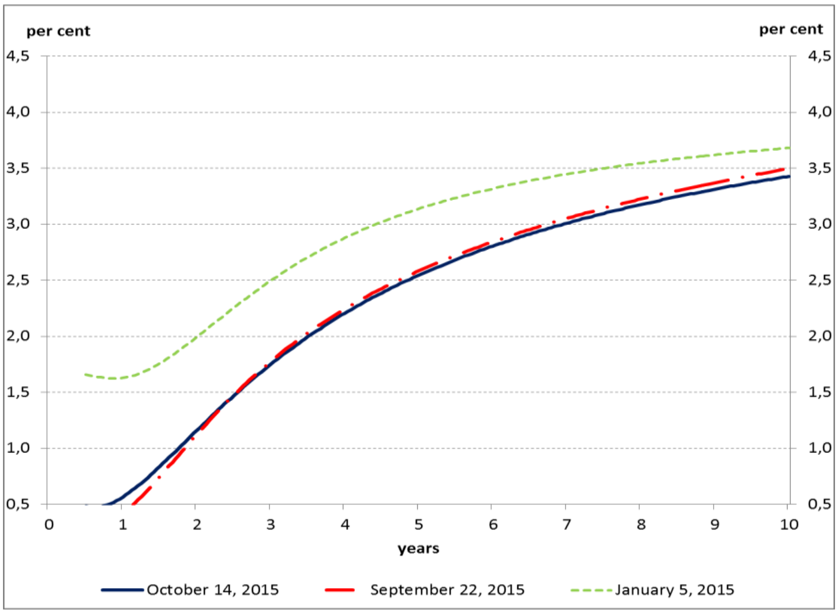
Chart 12: EUR/HUF exchange rate and the implied volatility of exchange rate expectations



Source: Bloomberg.

The long-term segment of the government securities market yield curve shifted downward by 9-10 basis points, while the short-term segment increased by 10-18 basis points (Chart 13). The long-term interbank yields showed a similar decrease.

Chart 13: Shifts in the spot government bond yield curve



Source: MNB, Reuters.

Demand at the government securities auctions during the period showed a mixed picture. Namely, while at the discount Treasury bill auction the Government Debt Management Agency reduced the planned, issuance of typically HUF 20 billion on several occasions, demands at the bond auctions were strong, which often led to higher issuance. **The average yields were in line with the secondary market trends.**

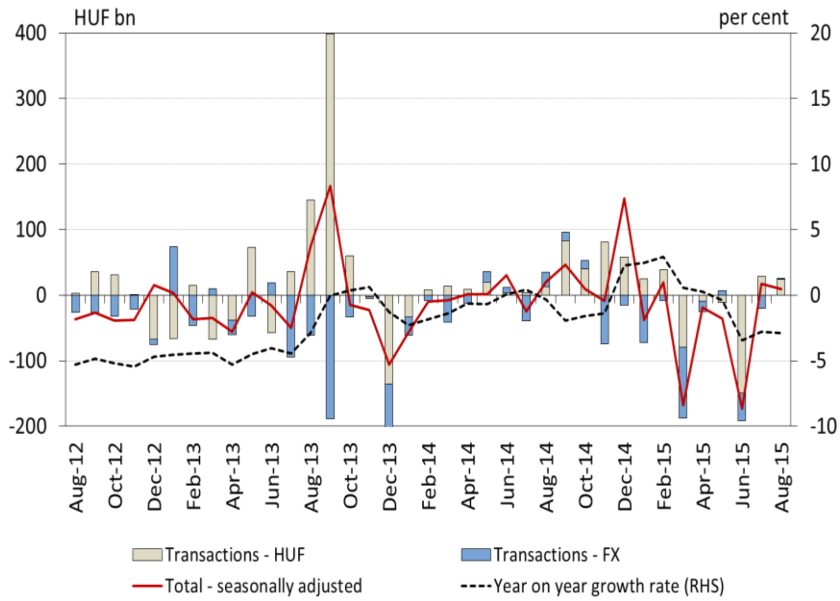
The non-residents' government securities holdings decreased by roughly HUF 100 billion since the last interest rate decision. The decreasing trend lasted until the end of the quarter, which is critical for the non-resident actors in terms of balance sheet optimisation, and a slight increase could be observed since then. **The Hungarian 5-year CDS spread fell by 8 basis points during the month, standing at around 164 basis points at present.**

3. TRENDS IN LENDING

In August, as a result of transactions, outstanding loans to non-financial corporations from the credit institutions sector increased by a total HUF 25 billion (seasonally adjusted by HUF 9 billion) (Chart 14). In terms of denomination, forint loans increased by some HUF 23 billion, while foreign currency loans rose by HUF 2 billion. The annual rate of decline in loans outstanding roughly corresponded to the July figure, and stood at 2.9 per cent. Loans granted under Pillar I of the FGS contributed by around HUF 31 billion to corporate lending in July.

In August, in the case of newly granted corporate loans, the average interest rate on small-value forint loans stood at almost the same level as in July, i.e. 4.39 per cent, but the average interest rate on higher-value forint loans decreased by 1.23 percentage points to 1.54 per cent. As the result of the decrease, the interest rate differential between small- and high-value new corporate loans increased in August.

Chart 14: Net borrowing by non-financial corporations

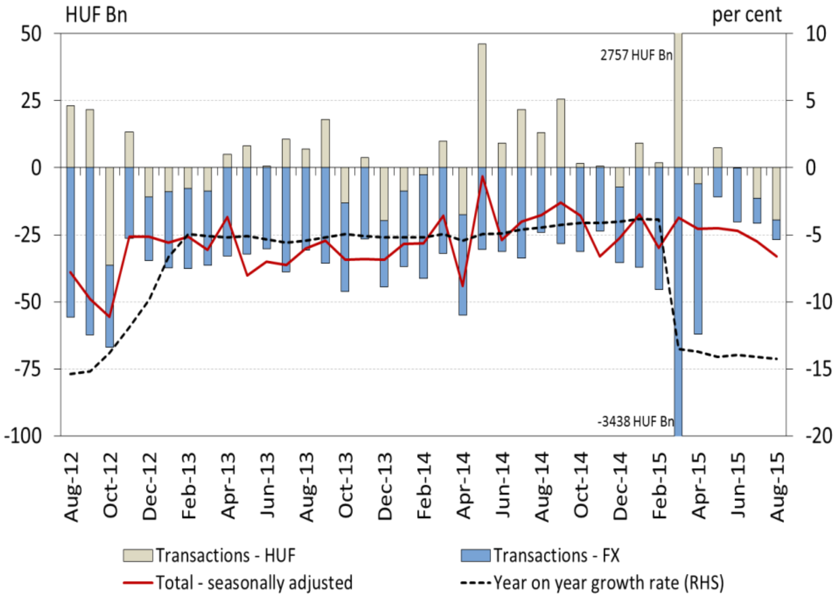


Source: MNB.

Outstanding loans of the household segment declined by HUF 27 billion as the result of loan transactions (Chart 15). Forint loans outstanding and total foreign currency loans fell by HUF 17 billion and HUF 10 billion, respectively. The annual rate of decline in the loans outstanding roughly corresponded to the July figure, and stood at 14.2 per cent. The volume of gross new loans lent in August by the entire sector of credit institutions to households amounted to HUF 63 billion in total, which is an increase of 37 per cent year on year.

Interest rates on new household loans, with the exception of the general purpose loans, slightly decreased in August compared to the previous month. There was no significant change in the annual percentage rate of charge (APRC) on housing loans, while the APRC on general purpose loan increased by 0.44 percentage points to 7.49 per cent.

Chart 15: Net borrowing by households



Source: MNB.