Macroeconomic and financial market developments

December 2013

Background material
to the abridged minutes of the
Monetary Council meeting
17 December 2013

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.

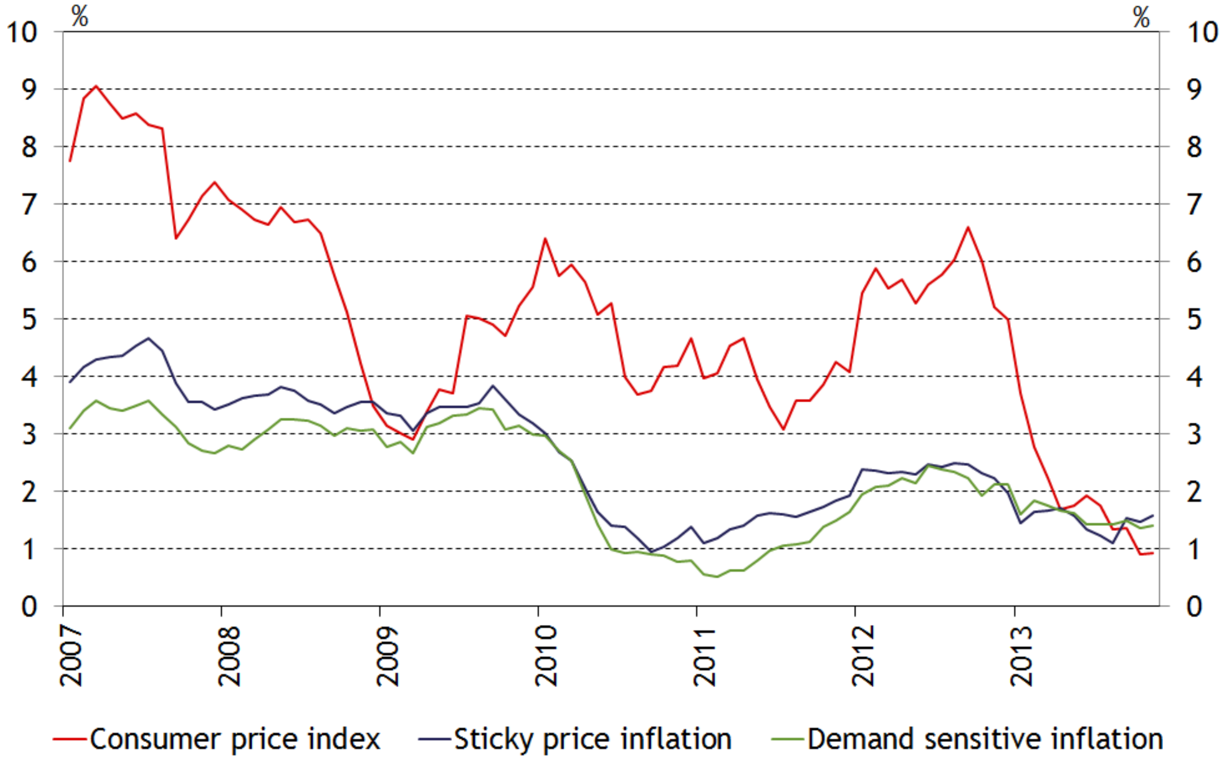
The abridged minutes and the background materials to the minutes are available on the MNB's website at:

http://english.mnb.hu/Monetaris_politika/decision-making/mnben_mt_jegyzokonyv

Macroeconomic developments

In November, the annual rate of consumer price inflation was 0.9%, unchanged from the previous month, but with a slight shift in its composition. Of the major components of inflation, food and administered price inflation fell, which was offset by increases in the annual indices for tradables and fuel prices. Indirect tax-adjusted core inflation stood at 1.2% in the month. Measures capturing the medium-term outlook for inflation were broadly unchanged relative to the previous month and have remained at low levels since the beginning of the year. Incoming data suggest that depressed demand is still holding back firms from passing on corporate costs to consumer prices.

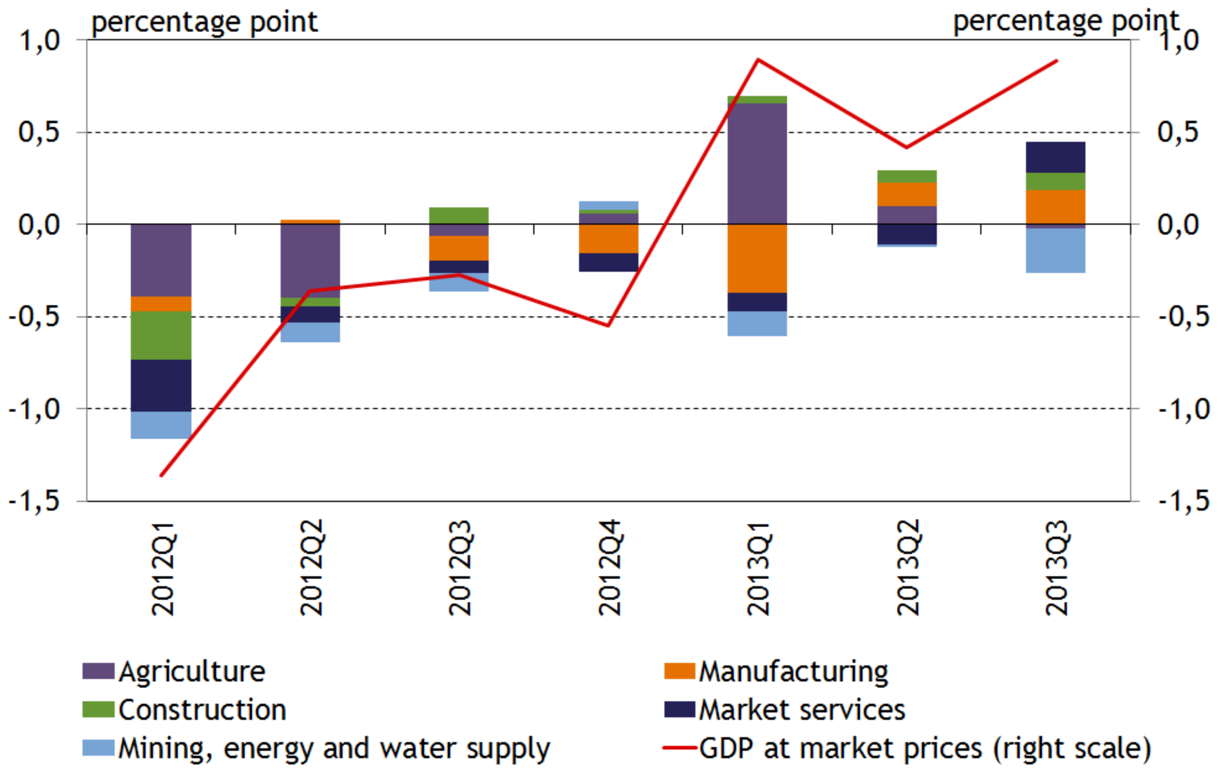
Chart 1: Measures of underlying inflation



Source: MNB.

According to the detailed release by the CSO, Hungary's gross domestic product grew by 1.8% in the third quarter of 2013 relative to the same period a year earlier. Seasonally adjusted, GDP expanded by 0.9% relative to the previous quarter. On the output side, value added increased most strongly in agriculture and construction. On the expenditure side, exports and investment were the main contributors to GDP growth. Manufacturing made the largest contribution to the improvement in the performance of investment. Within this, the performance of manufacture of transport equipment and the related supplier industries improved strongly. In addition, there has also been marked growth in investment by the transport, agriculture and trade sectors.

Chart 2: Main output components of GDP



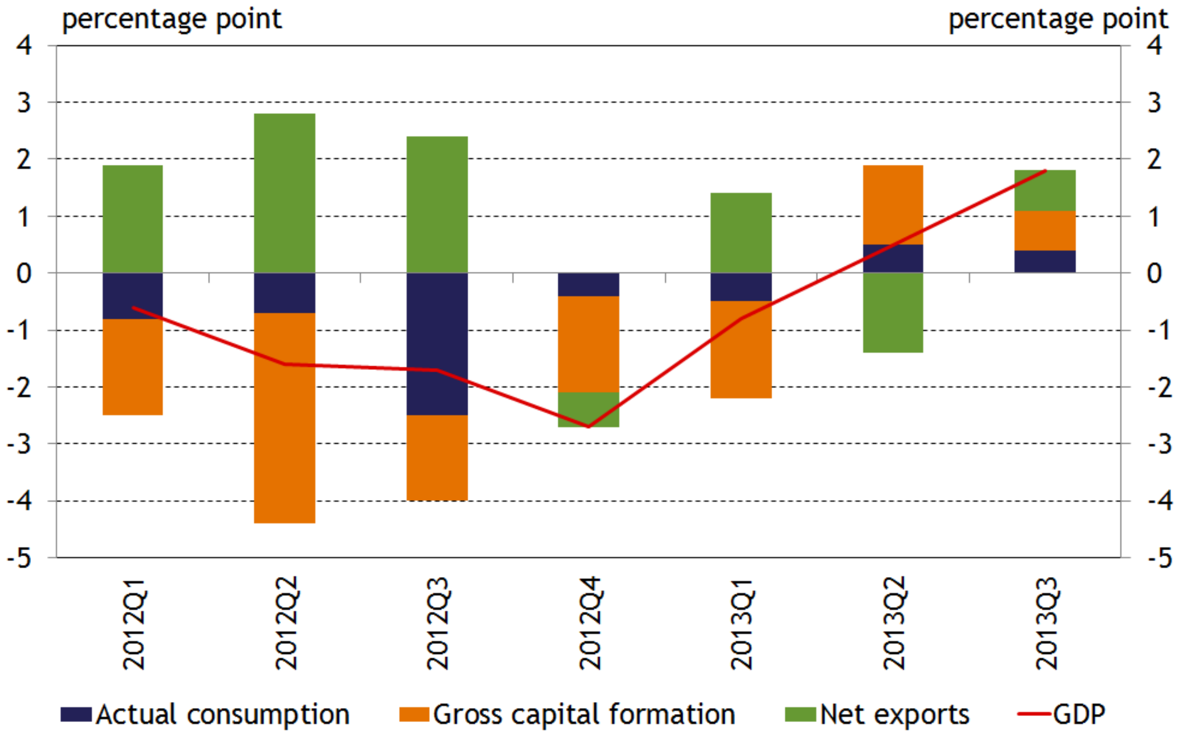
Note: The chart plots the contribution of private sector industries at basic prices.

Source: CSO.

According to preliminary monthly production data, industrial output increased by 6.0% in October 2013 on a year earlier. The index adjusted for working-day variations was the same as the unadjusted index, and, accordingly, output was 0.7% higher in the first ten months of the year than in the same period of the previous year. The industrial output index, adjusted for seasonal and working-day variations, fell by 0.5% in October relative to the previous month.

On the expenditure side of GDP, preliminary data indicated that the volume of retail trade increased by 2.5% in October after adjusting for calendar effects, suggesting continued growth in household consumption. The increase in vehicle fuel sales made a larger contribution to the pick-up in retail trade than in previous months. The marked increase in non-food sales may indicate a further gradual improvement in underlying trends.

Chart 3: Main expenditure components of GDP

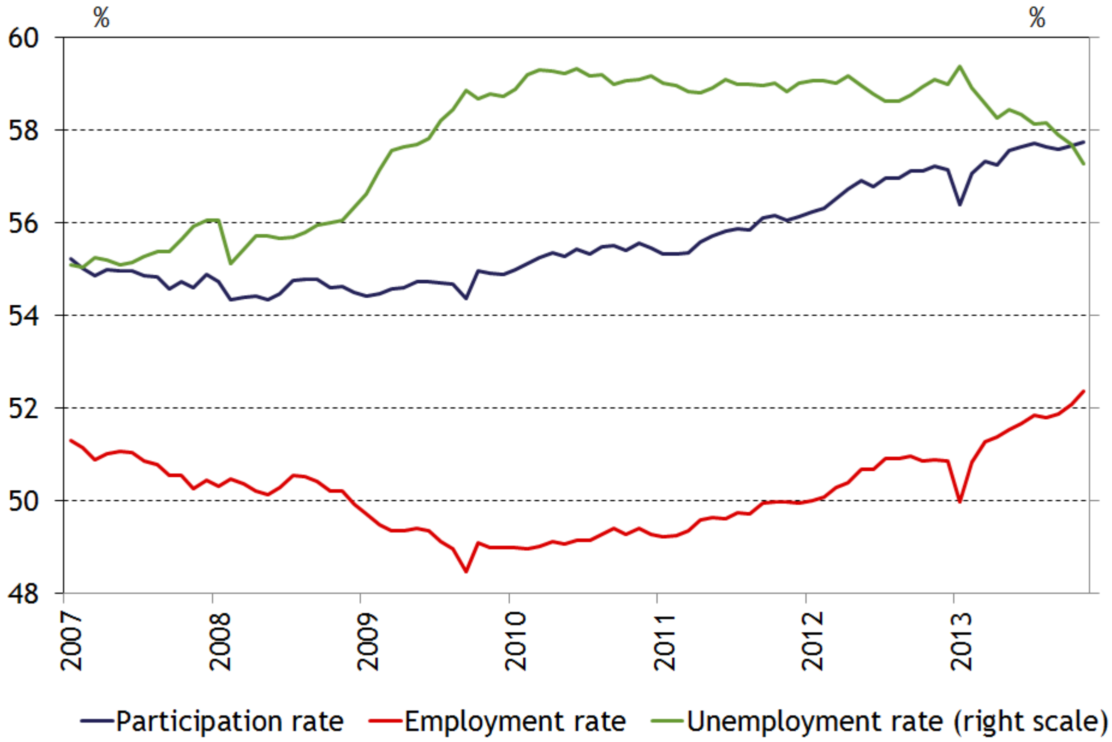


Source: CSO.

According to preliminary data, Hungary's balance of trade continued to improve in October. In euro terms, the value of exports increased by 4.7% and that of imports by 2.7% relative to October 2012.

According to Labour Force Survey data, the number of whole-economy employees in the 15–74 age bracket was 4,033,000, up 2.5% on the same period a year earlier. Based on the seasonally adjusted data, employment continued to increase, while the number of unemployed was little changed relative to the previous month, in line with the change in the number of registered unemployed. The unemployment rate stood at 9.8% in the period August–October.

Chart 4: Labour market indicators



Source: CSO.

Financial markets

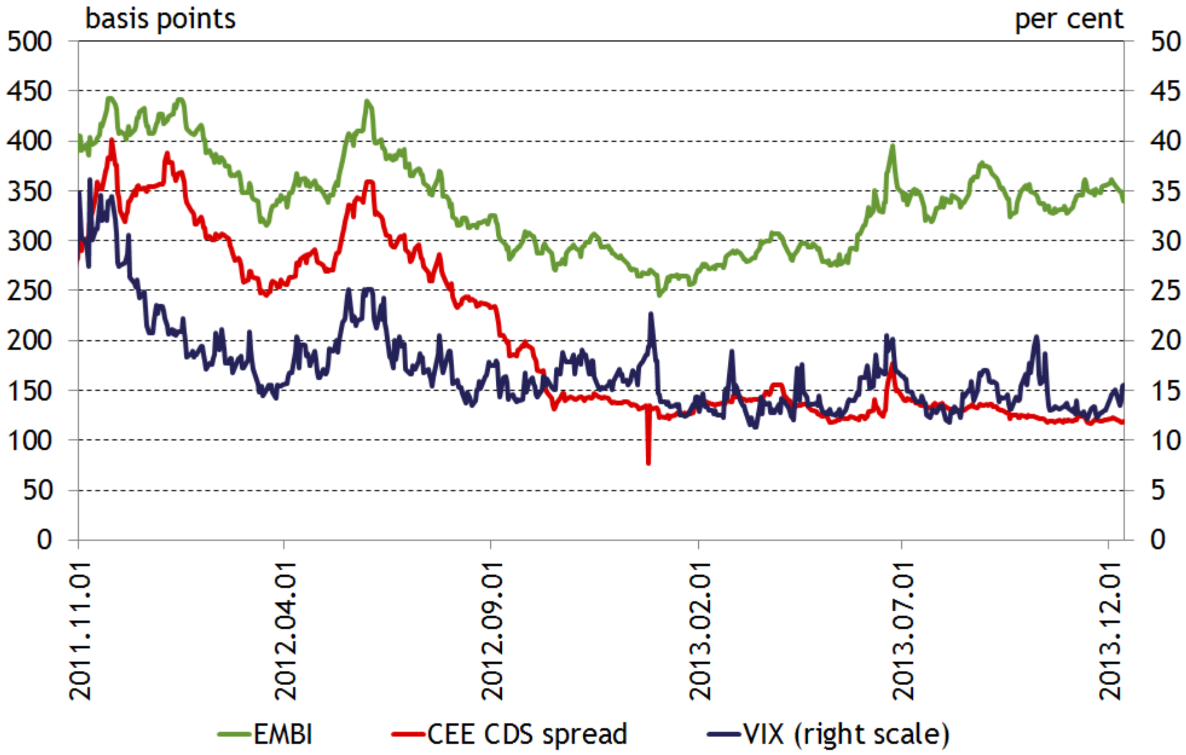
In the period since the Council's last interest rate decision in November,[1] market participants have continued to focus on the monetary policies of developed country central banks and macroeconomic data releases. The release of significantly better-than-expected growth and employment data in the US led to heightened expectations that the Federal Open Market Committee might start to reduce the pace of its asset purchases in December of this year, earlier than the likely date in March of next year. The agreement on the US federal budget also supported that view. However, statements by senior central bank officials continued to be mixed in this regard.

At its policy meeting in early December, the European Central Bank (ECB) left its policy rate unchanged after reducing it to 25 basis points in November. However, the low inflation path of the euro area remain the focus of market participants' attention, along with possible future liquidity-enhancing measures by the ECB. In his statement, the President of the ECB said that the issue of negative deposit rates was only briefly discussed at the meeting, and he did not suggest that the ECB would decide on the introduction of new liquidity-enhancing or other monetary policy instruments in the near future. The latest inflation data suggest that there is no risk of deflation in the euro area at the moment. At the same time, credit rating agencies' decision on Cyprus and Greece have contributed to an improvement, while the political tensions in Ukraine and the related economic risks caused a deterioration in sentiment.

On balance, the various risk indicators have changed only slightly since the Council's last interest rate decision: while the VIX index, a measure of the implied volatility of equity options, rose slightly, the EMBI Global, an indicator of returns on emerging market debt, fell marginally. Equity indices in the developed markets declined, and the US dollar depreciated against the euro and regional emerging country currencies. Yields on ten-year US and German government bonds rose by 10 basis points in the period. Movements in yields on ten-year government bonds in Central and Eastern European countries were mixed: Polish and Czech yields were little changed, while Romanian yields shifted up and Hungarian yields moved down.

[1] This section discusses market developments in the period 27 November to 13 December.

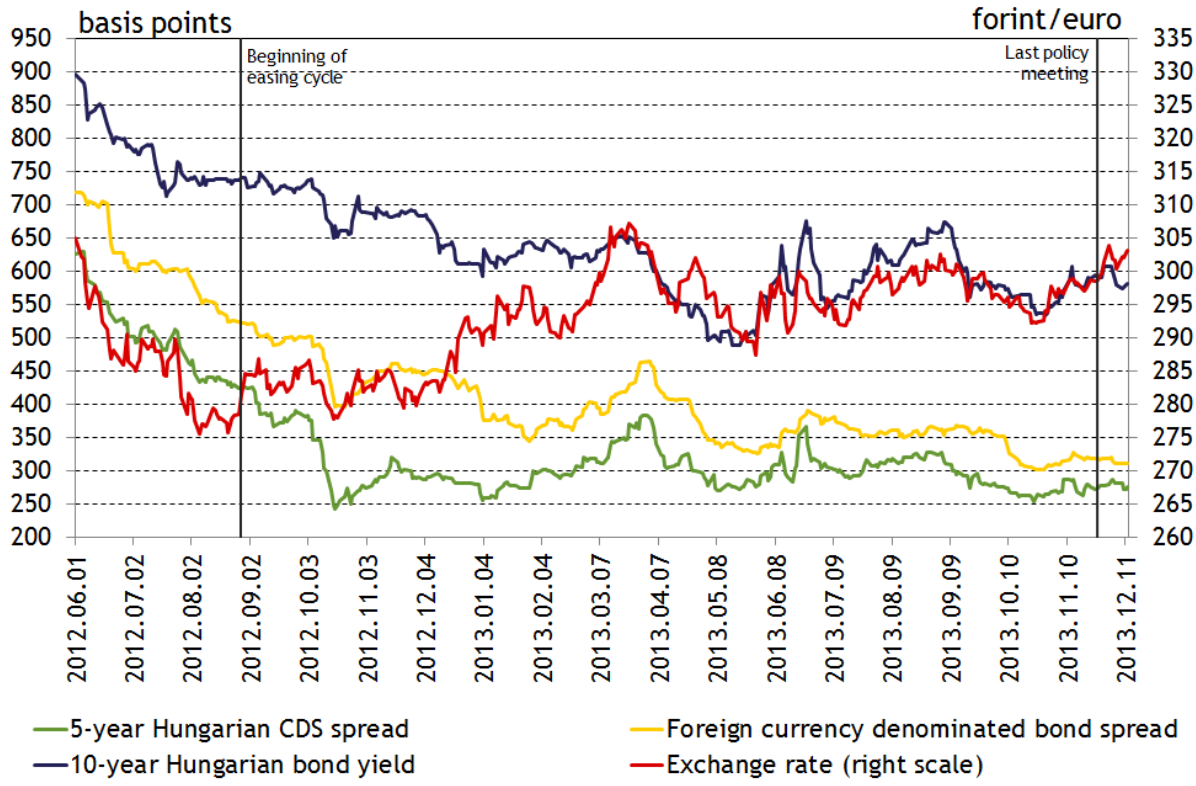
Chart 5: Major international risk indicators



Source: Thomson Reuters.

Relatively few domestic market-moving events have occurred in the period since the Council's November interest rate decision. On the whole, therefore, sentiment in Hungarian financial market was mainly influenced by international developments.

Chart 6: Domestic risk indicators

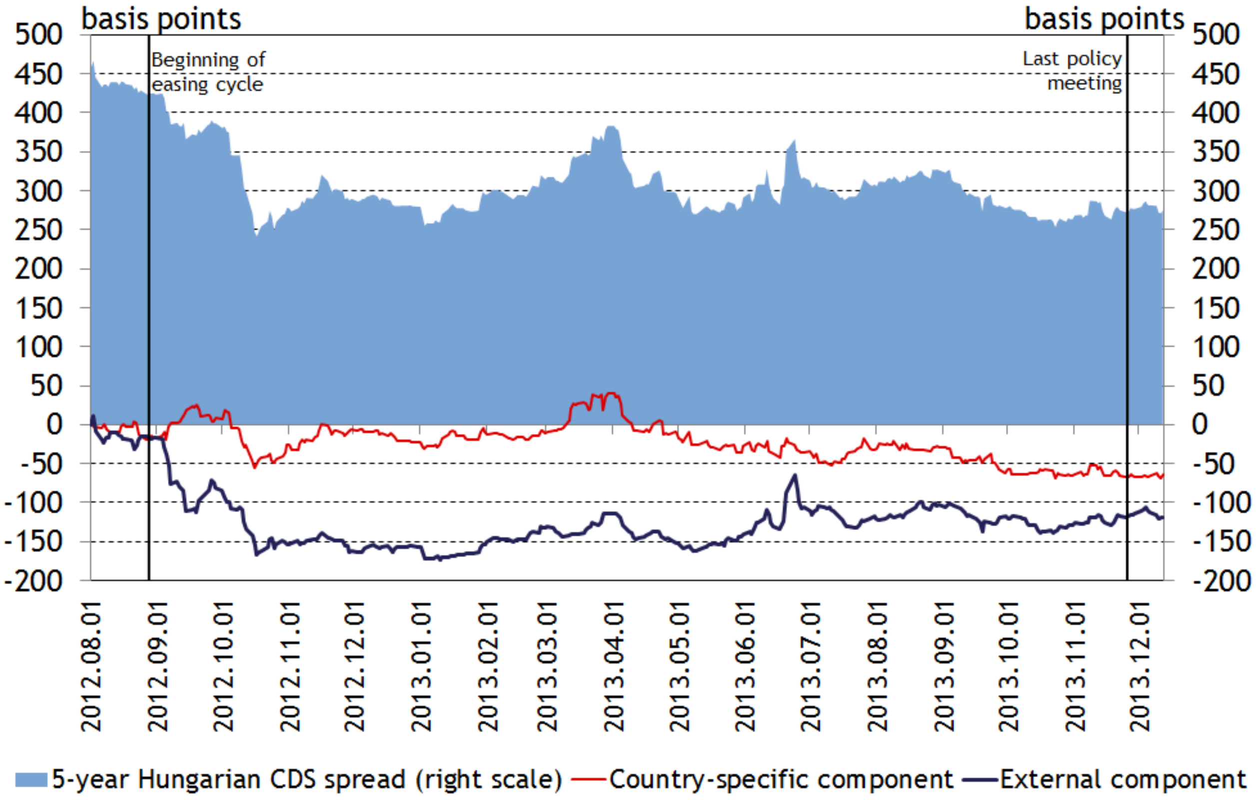


Source: Thomson Reuters.

On the whole, a mixed picture emerged from domestic market developments. The exchange rate of the forint fluctuated above the EUR/HUF 300 level until the end of the week preceding the Council's policy meeting, after depreciating by around 2% at the beginning of the month. This meant that the forint underperformed relative to other currencies of the region. The skewness measure of short-term exchange rate expectations rose slightly and non-residents further increased their short positions in the forint. As a result, long forint positions built up during the preceding six weeks have been completely unwound since the end of October.

Hungarian risk indicators painted a more positive picture: although the domestic five-year US dollar-denominated CDS spread remained unchanged, those on longer-term US dollar-denominated bonds fell by 5–10 basis points and those on euro-denominated bonds declined more strongly, by 30–50 basis points. Issues of forint-denominated government securities in the primary market were successful, with strong demand for both short and long-term paper. In contrast to the trend of previous months, the secondary market yield on three-month discount Treasury bills rose by a couple of basis points by the end of the period, while the ten-year benchmark yield fell by 15 basis points to 5.8% by the end of the period. As a result, the steepness of the yield curve for government securities decreased.

Chart 7: Decomposition of the Hungarian CDS spread



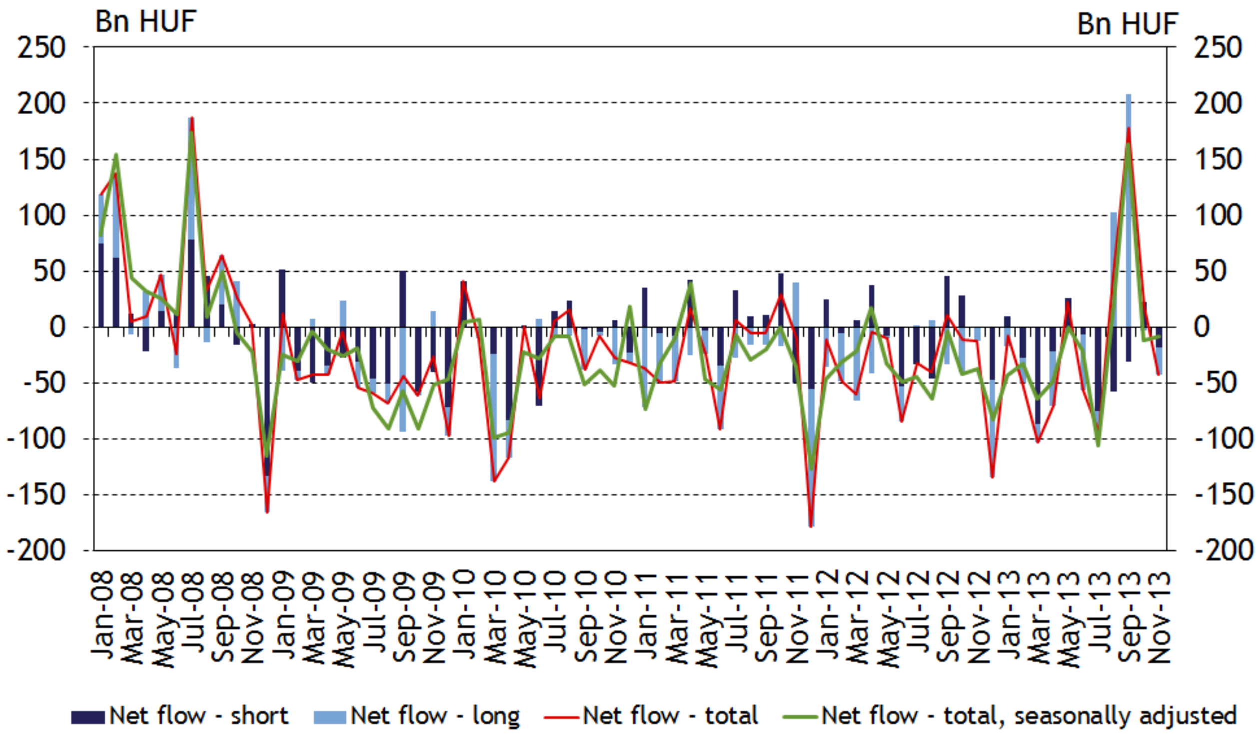
Source: Thomson Reuters.

Position of the banking sector

The level of the MNB's Financial Conditions Index (FCI) in the third quarter of 2013 indicates that financial conditions impaired economic growth to an increasingly lesser extent. Following an improvement in the second quarter, the index continued to approach zero in the third quarter.

The outstanding stock of lending by the seven largest Hungarian banks fell by a total of HUF 19.5 billion in November. That was a more favourable outcome than in the two years prior to introduction of the Funding for Growth Scheme. The stock of foreign currency loans fell by HUF 21.4 billion and that of forint loans increased by HUF 1.9 billion. In October, average interest rates on both small and large forint loans fell.

Chart 8: Bank lending to the corporate sector



Note: The contents of lending volumes are different from the transaction values published in monetary statistical publications, as, in contrast to the latter, they include write-offs and asset disposals also affecting outstanding stocks.

Source: MNB.

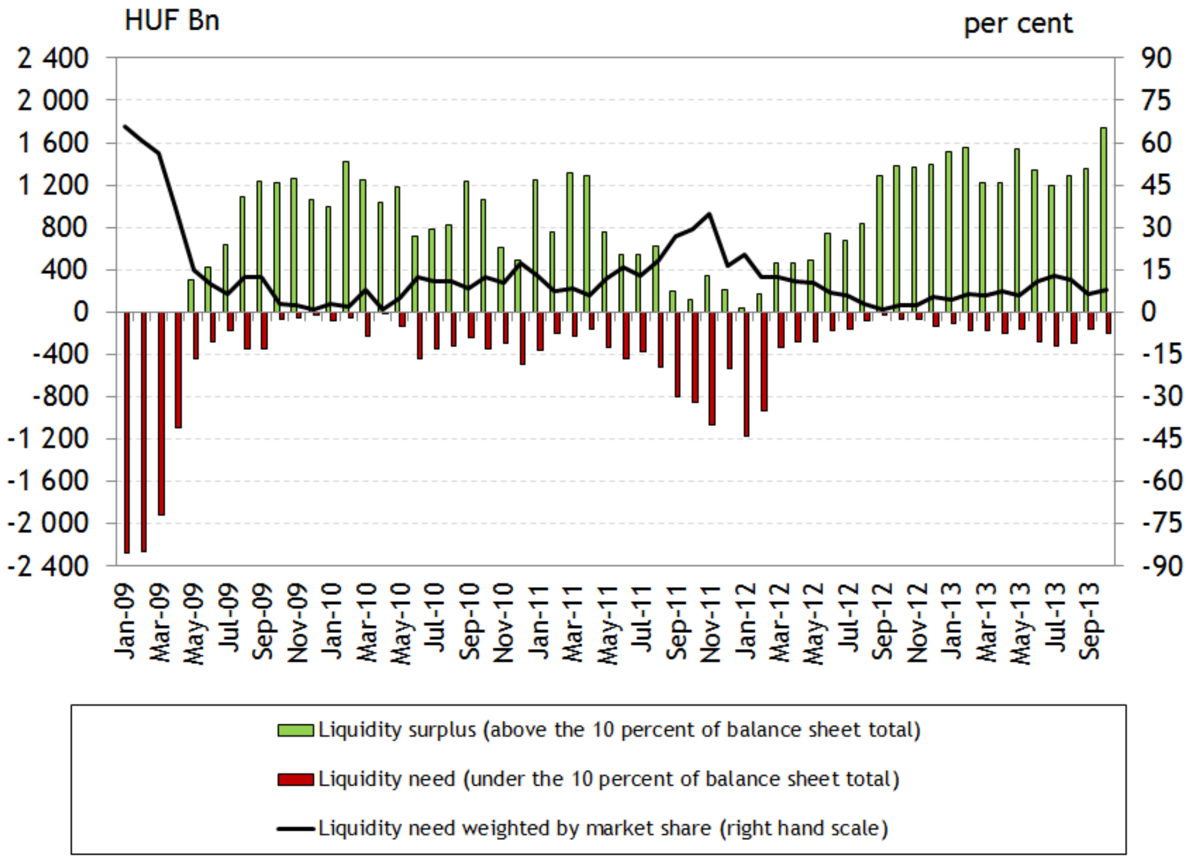
Outstanding lending by the seven largest banks to households continued to decline in November. The stock of loans fell by a total of HUF 27 billion, with foreign currency loans and forint loans, respectively, accounting for HUF 23 billion and HUF 4 billion of the decline. Average interest rates on new housing loans and equity loans to the household sector fell further in October.

The System-Wide Financial Stress Index, a measure of the level of stress from the sub-markets of key importance for financial stability, remained at a low level in the past month and at a distance from the danger zone.

According to the results of stress tests, the banking sector's liquidity level is only slightly short of the regulatory limit. The Liquidity Stress Index remained essentially unchanged at 7.9%, while the positive liquidity buffer increased. At the level of individual banks, none would be left insolvent in the wake of a shock. Overall, the liquidity position can thus be regarded as adequate.

The ratio of non-performing household loans rose to 18.3% in the third quarter. The profit-reducing impact of provisioning rose by less than 0.1% to 2.8%. A slight increase in the number of defaults coupled with rising impairment maintained loan loss coverage at over 50%. Within the corporate loan portfolio, the ratio of borrowers with loans overdue for more than 90 days fell to 19.5%. This also resulted from an increase in the corporate loan portfolio for the first time since the onset of the crisis, along with the relatively low portfolio deterioration. The profit-reducing impact of provisioning fell slightly to 3.2%. This was sufficient to maintain coverage of over 55%.

Chart 9: A Liquidity Stress Index, banks' liquidity surplus or deficit compared to the regulatory limit along the stress path

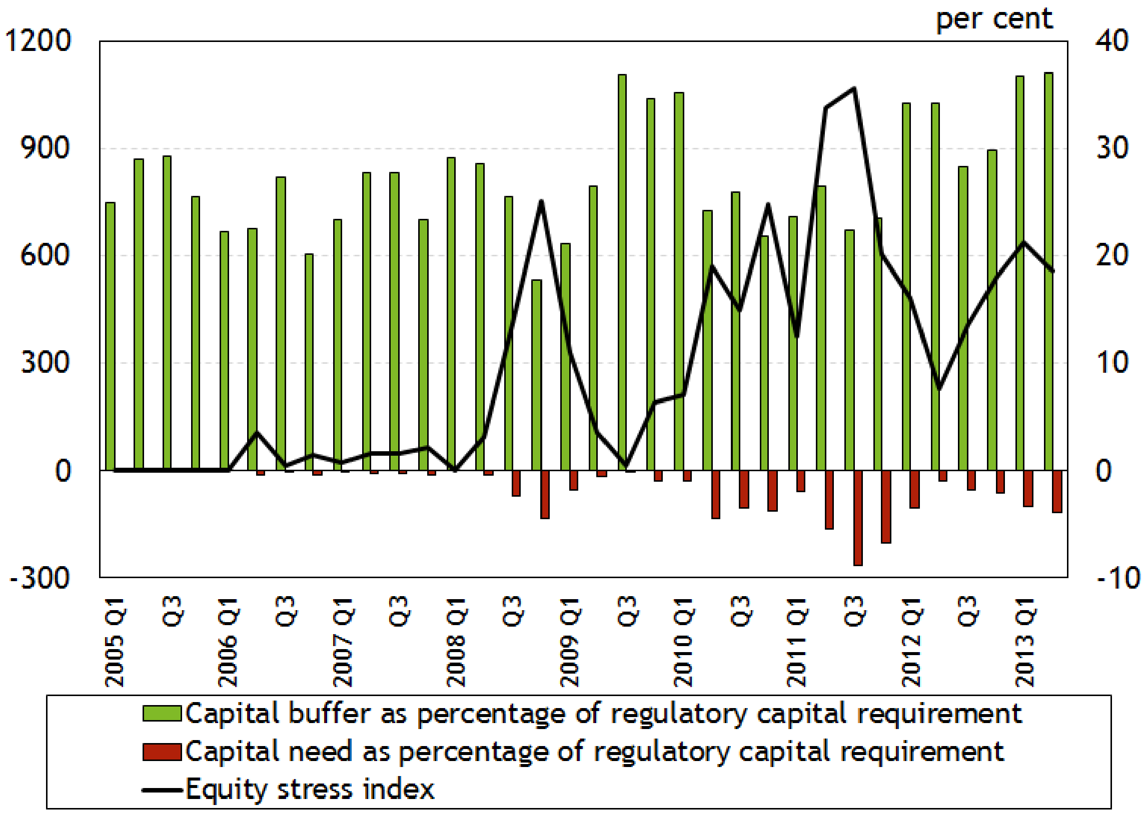


Source: MNB.

At the end of October 2013, the banking sector's cumulated pre-tax profits amounted to HUF 86 billion, substantially higher than last year's profits of only HUF 21 billion, but still low by historical standards. One single bank accounted for the bulk of this figure. Four of the large banks posted losses.

The average capital adequacy ratio increased, standing at 17.2% in late October 2013, while the distribution of capital adequacy remains asymmetrical. The results of the Solvency Stress Index launched in Q2 2013 and applying to a two-year horizon indicate a lower stress level compared to the previous period.

Chart 10: Capital buffer and capital shortage along the stress path at the end of the eight-quarter horizon (as a percentage of capital requirement)



Source: MNB.