Macroeconomic and financial market developments

February 2014

Background material
to the abridged minutes of the
Monetary Council meeting
18 February 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 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:

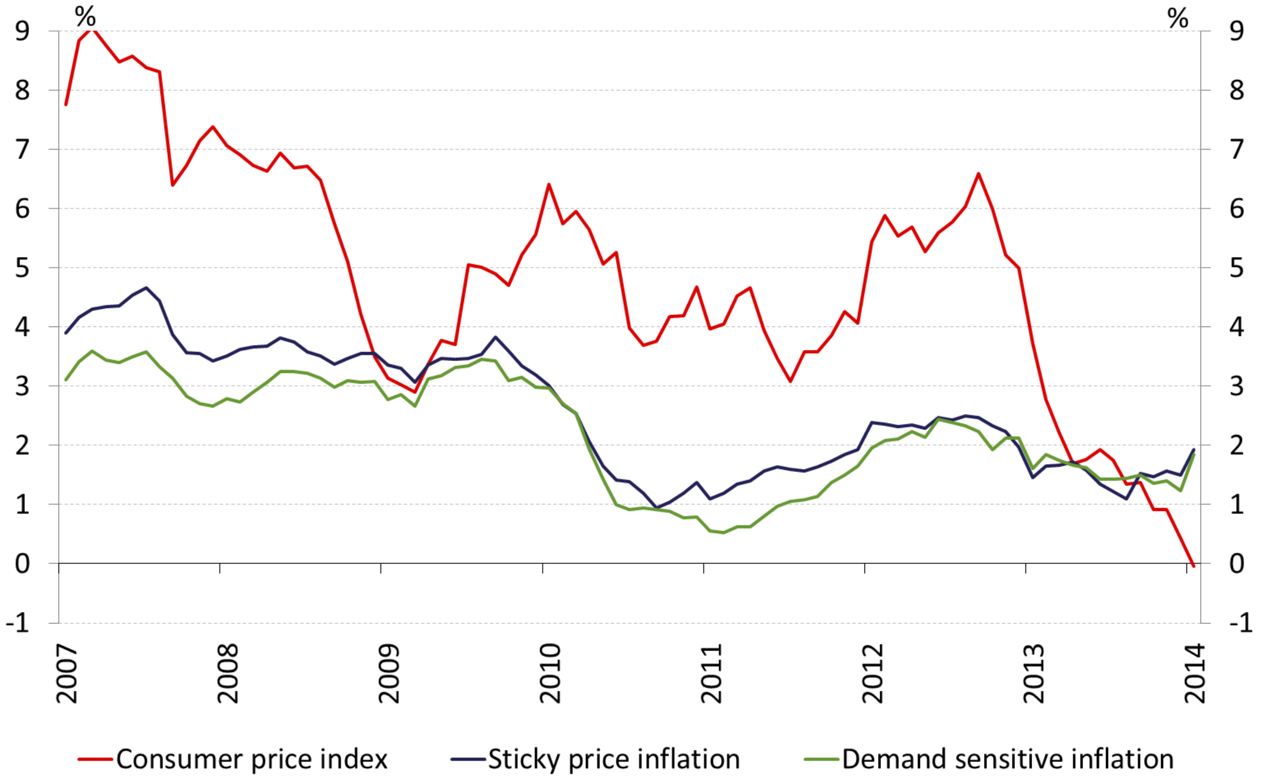
http://english.mnb.hu/Monetaris_politika/decision-making/mnben_mt_jegyzokonyv

Macroeconomic developments

On the whole, the macroeconomic data available since the Council's December interest rate decision were consistent with the key projections in the December issue of the *Quarterly Report on Inflation*. Inflation remained subdued, along with signs of a gradual pick-up in the real economy and the labour market. Based on last month's data, inflation in the short term was slightly lower than in the December projection. The Bank's measures of underlying inflation capturing the medium-term outlook rose relative to the previous month, but continued to indicate moderate inflationary pressures in the economy.

In the December *Report*, the macroeconomic environment is projected to be disinflationary in the coming quarters. Inflation is expected to remain below 3 per cent over the entire forecast horizon, reflecting moderate commodity and import prices, subdued consumption demand and the adjustment of inflation expectations. Tax-adjusted core inflation is projected to rise from its current low level starting from the second quarter of 2014, as domestic demand picks up gradually.

Chart 1: Measures of underlying inflation



Sources: CSO, MNB.

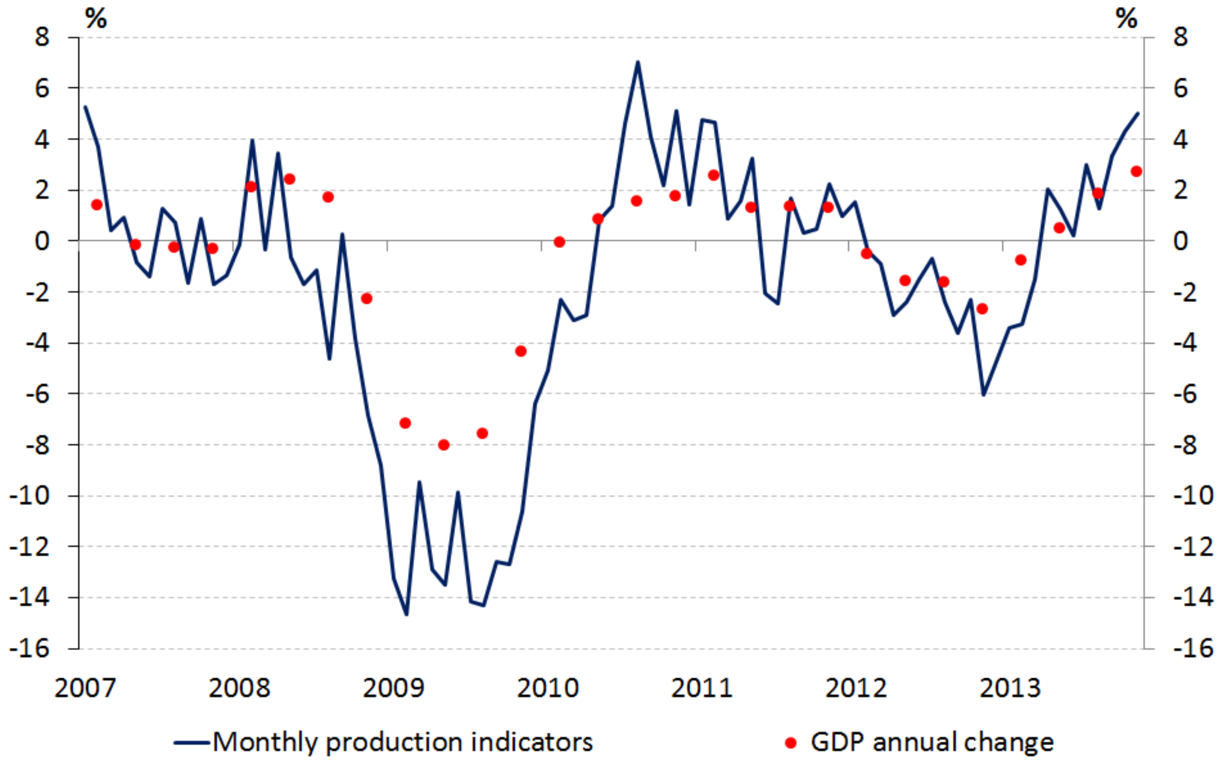
In January 2014, the consumer price index stood at 0 per cent, core inflation at 3.4 per cent and indirect tax-adjusted core inflation at 1.6 per cent. Accordingly, headline inflation fell by 0.4 percentage points and core inflation by 0.2 percentage points relative to the previous month. The January decline in annual consumer price inflation reflected the drop in fuel prices. The Bank's measures of underlying inflation rose slightly relative to the previous month, with strong base effects being a contributing factor. All measures continued to point to a subdued inflation environment.

Inflation in December and January turned out to be lower than in the December *Report's* baseline projection. The difference stemmed mainly from the fact that developments in fuel and food prices were more moderate than expected.

Positive cost-side and demand factors may have also contributed to subdued developments in underlying inflation. Agricultural producer prices fell by 14.6 per cent year-on-year in November 2013. Domestic sales prices of the sectors producing consumption goods rose by 1.1 per cent in December 2013 relative to the same period of the previous year. The price of Brent crude oil has also fallen in recent weeks relative to the end of last year. Retail trade data suggest that consumption demand may have picked up gradually at the end of last year, but retail trade turnover continued to be significantly below levels seen during the years prior to the crisis. Consequently, the domestic demand environment may continue to have a disinflationary impact looking forward.

In the December projection, economic activity picks up gradually, reflecting the increasing contribution from domestic demand, in particular investment activity in the short run, in addition to exports.

Chart 2: Monthly production indicators and annual change in GDP



Note: The monthly production indicator is the weighted average of industrial output, construction output and retail sales. The weights are derived from regression where GDP is determined by these three indicators.

Source: MNB.

In the fourth quarter of 2013, GDP growth was consistent with the December baseline projection. Gross domestic product grew by 2.7 per cent in the fourth quarter relative to the same period of the previous year, and by 1.1 per cent in 2013 as a whole. The economy expanded by 0.6 per cent in the fourth quarter after growing by 0.8 per cent in the third quarter.

In year-on-year terms, the output of the main economic sectors rose markedly in December, but fell slightly relative to the previous month. Longer-than-usual holidays due to timing of public and bank holidays may have also contributed to the decline relative to November. Industrial production rose by 6.8 per cent following last year's low base. Motor vehicle production, which performed well in the final month of the year, continued to be the engine of manufacturing output growth. However, industrial output slowed in the fourth quarter as a whole, with the decline in the electronic and optical industry output being a contributing factor. Construction output grew by 11.4 per cent year on year, but fell by 1.3 per cent relative to the previous month. New industrial orders increased in both manufacturing and construction at the end of the year, suggesting a continued upturn in economic activity.

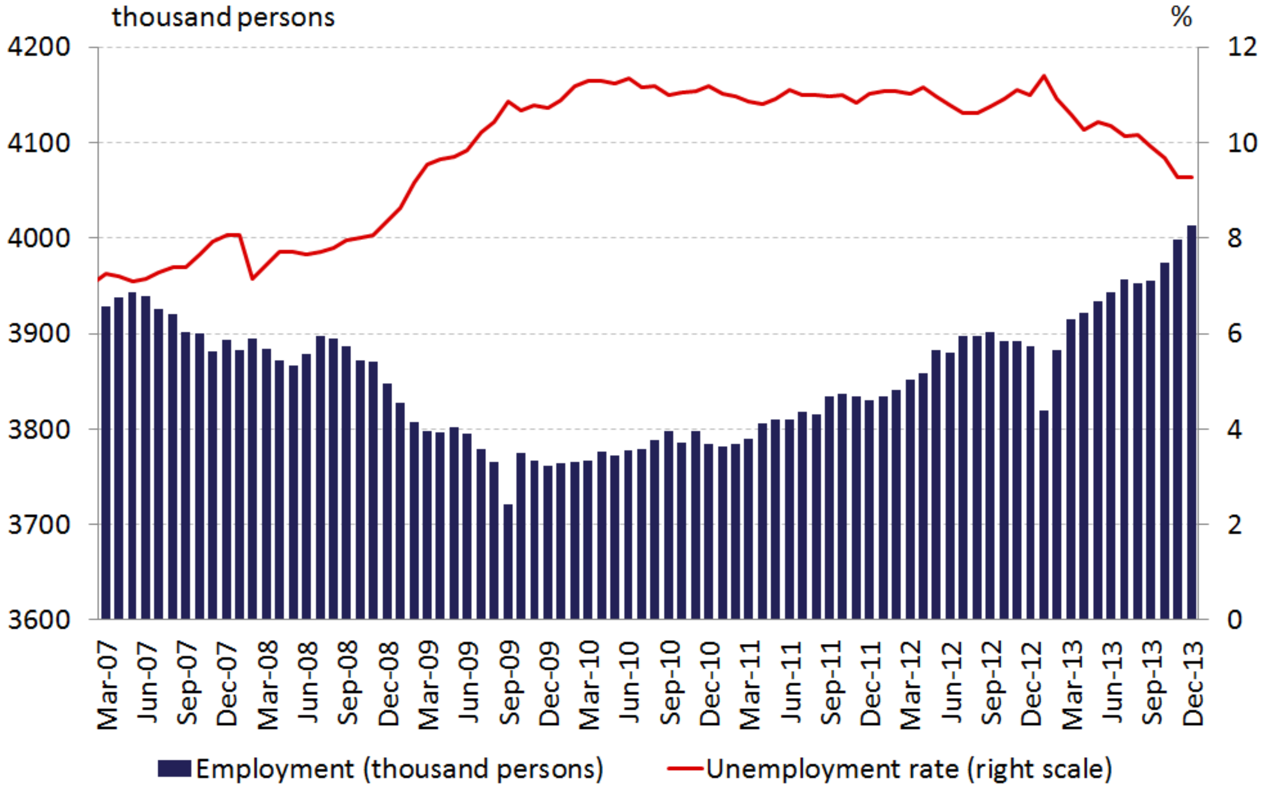
Expenditure side developments confirmed the key messages from the December projection. Preliminary data indicated that the volume of retail trade continued to rise in December (by 1.8 per cent relative to the same period of the previous year). Rising sales of non-food items, in addition to fuel and food items, also contributed to this growth. Improving consumer confidence, in addition to rising real wages, also supported the recovery in household consumption. Credit supply developments reflected the slow easing of consumer credit conditions.

The trade surplus continued to rise in December, with the rate of growth in goods trade accelerating relative to previous months. The trade surplus increased by EUR 150 million relative to the same period of 2012, with the December surplus nearly doubling. For 2013 as a whole, the values of exports and imports rose by 2.5 per cent and 1.8 per cent, respectively. The trade surplus was EUR 617 million higher than a year earlier. Based on these factors, the contribution of net exports to economic growth may have remained strong in the fourth quarter of 2013.

In the projection in the December *Report*, employment rises further and wage growth remains subdued. Available data show rising employment and falling unemployment, in line with the projection. According to the December Labour Force Survey, the number of employees in the 15–74 age bracket amounted to 4,007,000, up 2.6 per cent on the same period a year earlier. The expansion in employment under the public work scheme and the rise in private sector employment (mainly in manufacturing) both contributed to the increase in employment. The number of unemployed fell markedly relative to the previous month; the unemployment rate stood at 9.3 per cent in December.

Private sector wage data for November showed an increase in the growth rate of gross average earnings, with private sector earnings rising by 5.3 per cent relative to the same period a year earlier. Faster earnings growth mainly reflected rising wages in manufacturing. Meanwhile, regular pay growth in market services continued to be muted.

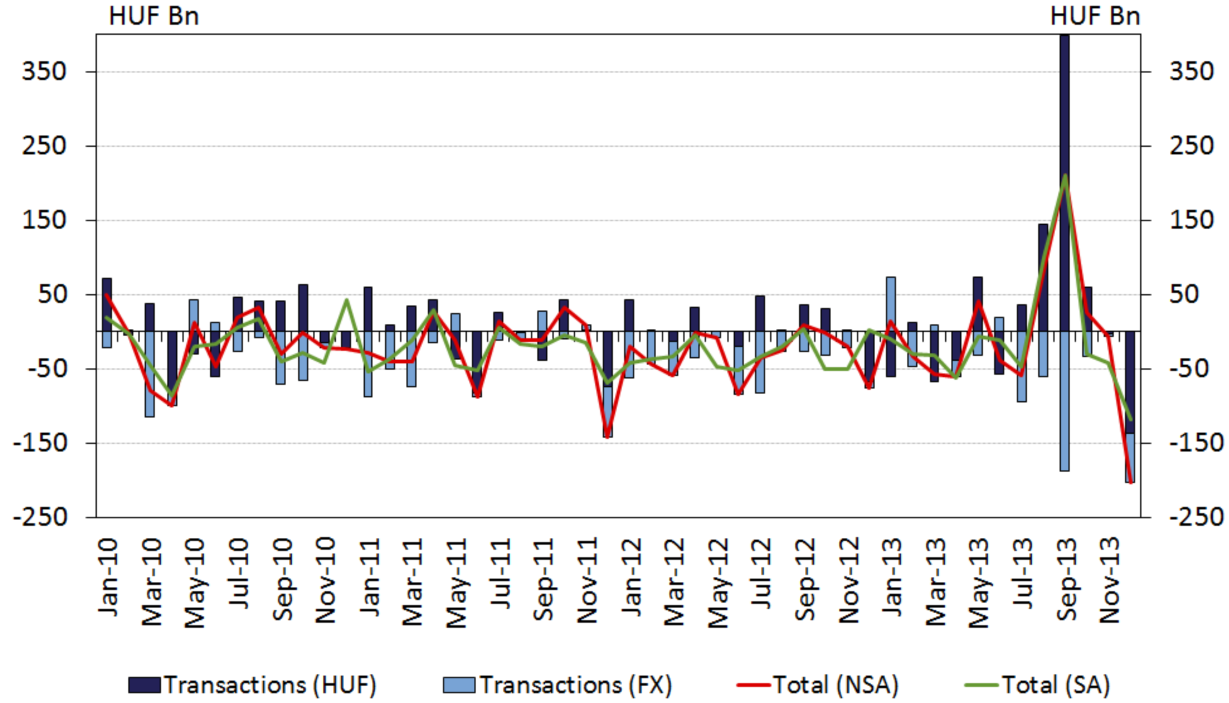
Chart 3: Labour market indicators



Source: CSO.

Seasonally adjusted bank loans to the non-financial corporate sector fell by HUF 118.4 billion on a transaction basis and by 204.3 billion unadjusted for seasonal effects in December, with one-off factors playing a significant role. The stocks of forint and foreign currency loans declined by HUF 136.2 billion and HUF 66.3 billion, respectively, on a transaction basis.

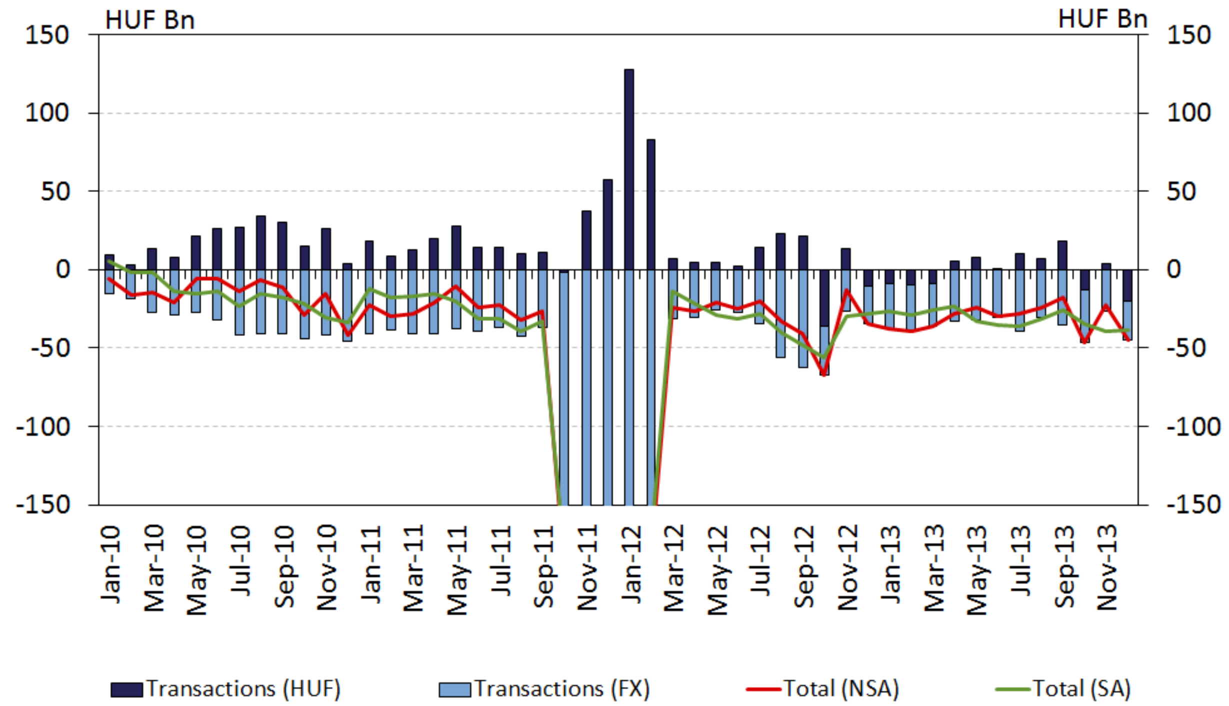
Chart 1: Corporate loan portfolio



Source: MNB.

Seasonally adjusted household loans fell by HUF 38.4 billion on a transaction basis and by HUF 44.8 billion unadjusted for seasonal effects in December. This reflected a decline of HUF 20.0 billion in forint loans and a drop of HUF 24.8 billion in foreign currency loans, due to transactions.

Chart 5: Household loan portfolio

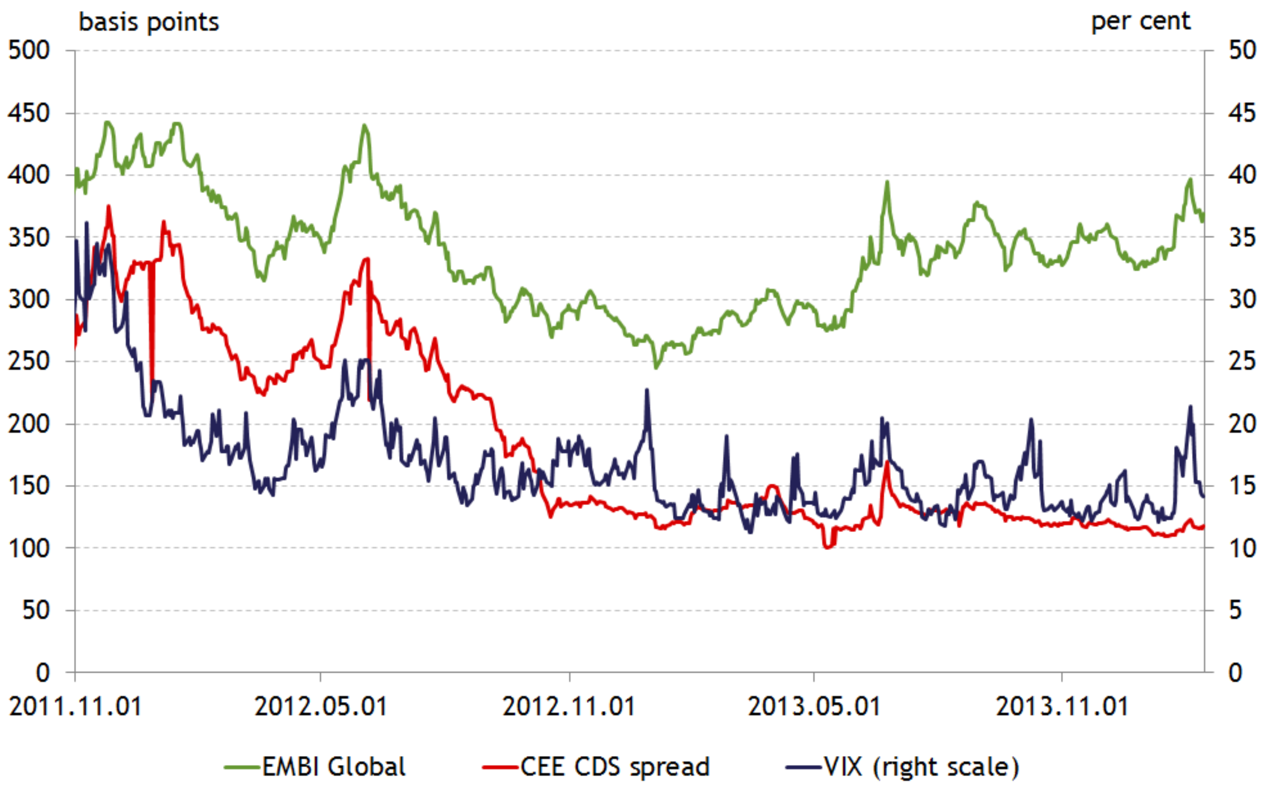


Source: MNB.

Financial markets

In the short period since the Council's January interest rate decision,[1] investor risk aversion increased, with a resulting deterioration in sentiment and turbulent trading conditions in money and capital markets. The main reason for this was increased attention to developments in the emerging markets, the vulnerability of emerging market economies and the related concerns, in addition to the monetary policies of leading central banks. Those concerns, in turn, had an effect on developed financial markets. Negative developments in the countries already seen as 'vulnerable' (including Turkey, Argentina, South Africa and Ukraine) placed emerging regions under pressure, with the currencies of Central and Eastern European economies depreciating sharply. Concerns about the slowdown in the Chinese economy and, even though it was consistent with expectations, the Fed's decision to further reduce the pace of its asset purchase programme also contributed to the deterioration in sentiment. Markets stabilised somewhat and there was a slight reversal at the end of the period.

Chart 6: Major international risk indicators



Source: Thomson Reuters.

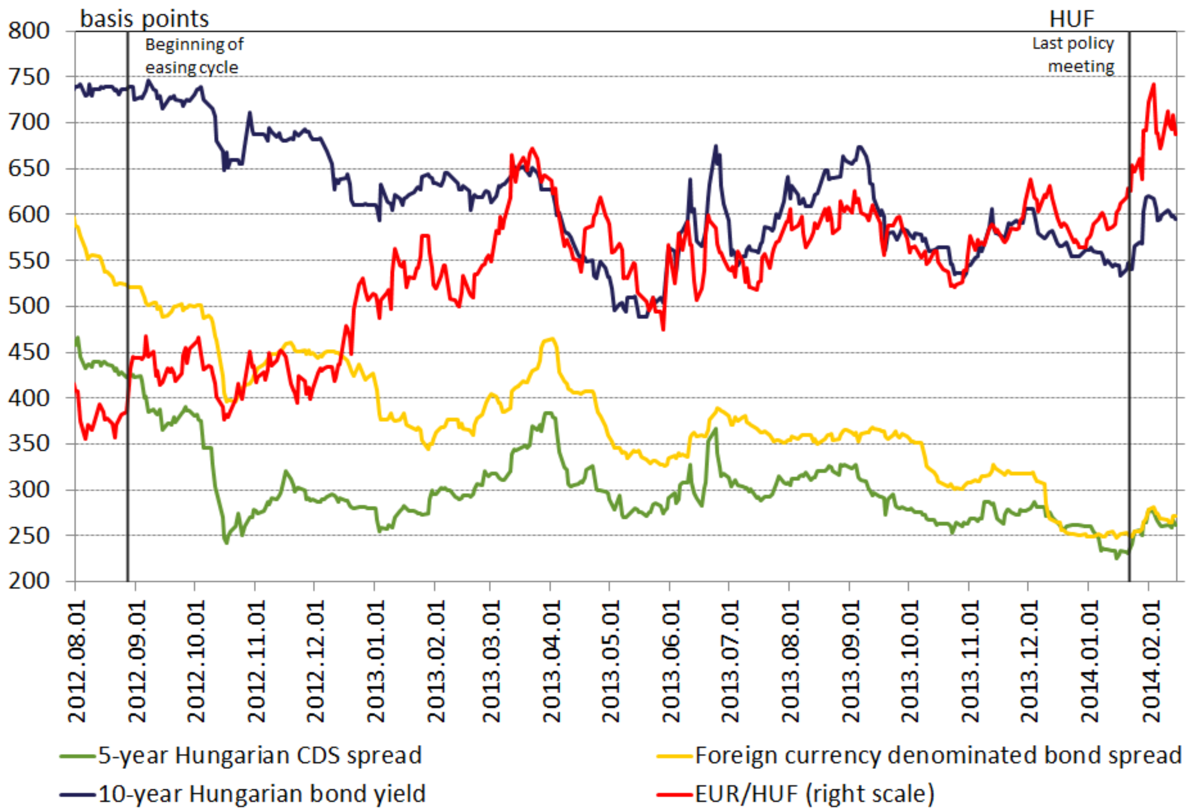
The European Central Bank (ECB) and the Bank of England left their key policy rates unchanged and maintained their forward guidance. At its policy meeting in late January, Turkey's central bank tightened monetary conditions slightly by changing its other conditions, while leaving interest rates unchanged. This, however, did little to calm the markets, with the lira continuing to weaken following the policy meeting. At its meeting a few days later, the Turkish central bank

[1] The chapter on financial markets focuses on the period between the January and February interest rate decisions; the data collection period was closed on 14 February, the Friday preceding the interest rate decision.

decided to raise its policy rate significantly in response to the continued depreciation of the lira; however, this only provided temporary relief for the markets. During the same week, India's central bank raised interest rates by 25 basis points to 8 per cent andthe central bank of South Africa surprised the markets by raising its key rate by 50 basis points to 5.5 per cent.

The various risk indicators have risen sharply since the Council's last interest rate decision: the VIX index, a measure of the implied volatility of the US equity market, rose by 4.3 percentage points, and the EMBI Global, an indicator of emerging countries' bond market developments, rose by 34 basis points. With sentiments deteriorating, developed country equity indices suffered sharp losses. The Swiss franc and the Japanese yen, widely perceived as safe haven currencies, appreciated against the US dollar. At the same time, long-term yields in developed markets continued to fall significantly, closely related to the global weakening of risk appetite. However, the deterioration in sentiment had little or no adverse impact on the long-term yields in periphery countries, where yields declined only modestly. By contrast, yields on government securities in emerging economies rose significantly during the period of turbulence. Ten-year yields on Polish, Romanian and Hungarian bonds rose by 11–56 basis points in the period. By contrast, yields in the Czech Republic moved lower.

Chart 7: Domestic risk indicators



Source: Thomson Reuters.

In the period since January's interest rate decision, relatively few domestic market-moving events occurred. Of these, the agreement on the expansion of the Paks nuclear plant, the announcement of latest reduction in utilities prices by the Government and the statements by central bank decision-makers on future interest rate policy deserve special mention.

Developments in the Hungarian foreign exchange market and in risk indicators were unfavourable. Following a slight depreciation at the beginning of the period, the forint weakened rapidly, before reversing some of the decline at the end of the period. On the whole, the forint has depreciated by 2.1 per cent against the euro since the last interest rate decision, underperforming relative to other currencies in the region. The Hungarian five-year CDS spread rose by around 30 basis points, in line with movements in other indicators in the region. Spreads on euro and dollar-denominated bonds rose by 30 basis points.

The results of issues of forint-denominated government securities in the primary market were mixed. Following weak demand in the first half of the period, the issuer managed to raise the quantities of short and long-term securities sold in the second half. Yields in the secondary market rose by 30–40 basis points. The steepness of the yield curve for government securities increased to another record high in the middle of the period, before falling slightly.