Macroeconomic and financial market developments

January 2014

Background material
to the abridged minutes of the
Monetary Council meeting
21 January 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:

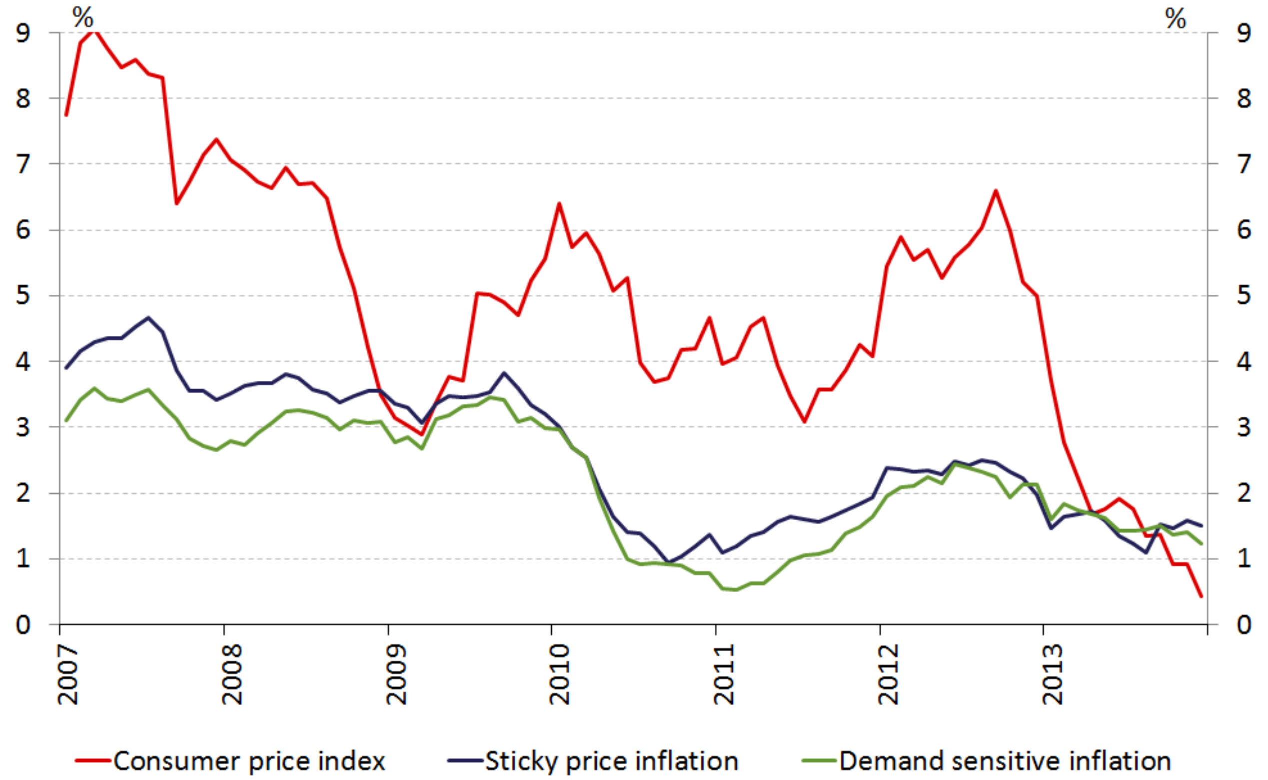
http://english.mnb.hu/Monetaris_politika/decision-making/mnben_mt_jegyzokonyv

Macroeconomic developments

On the whole, the macroeconomic data received since the Council's December interest rate decision corroborated the core messages of the December issue of the *Quarterly Report on Inflation*. Inflation remained subdued, alongside signs of a gradual pick-up in the real economy and the labour market. Based on last month's data, short-term inflation is slightly lower than in the December projection. January data could provide relevant new information on the underlying developments in inflation.

The December *Report* predicted a macroeconomic environment marked by disinflationary conditions for the coming quarters. Moderate commodity and import prices, subdued consumption demand and the adjustment of inflation expectations may result in inflation remaining below 3 per cent over the entire forecast horizon. Core inflation adjusted for tax changes is forecast to rise from its current low point starting from the second quarter of 2014, as domestic demand picks up gradually.

Chart 1: Measures of underlying inflation



Source: MNB.

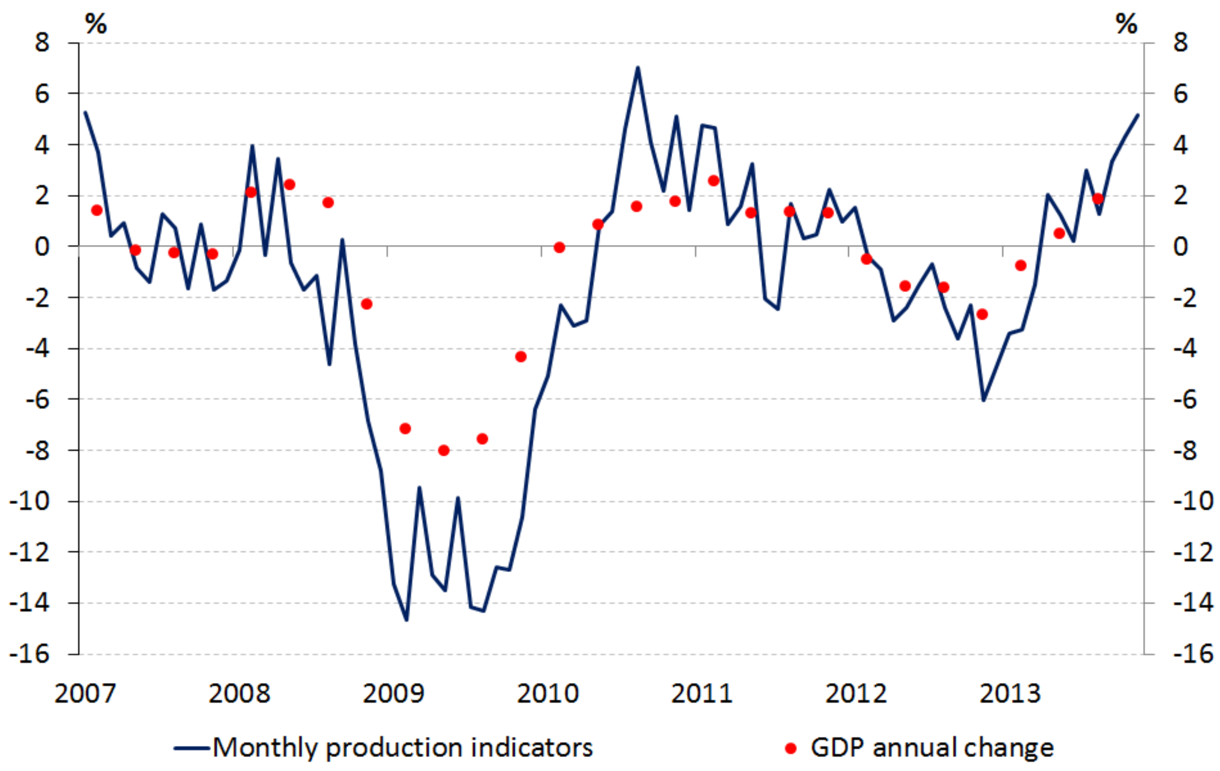
December's inflation data was in line with the key messages of the latest *Report*. The consumer price index continued to decline, reaching 0.4 per cent in December. Core inflation stood at 3.6 per cent, and indirect tax-adjusted core inflation came in at 1.1 per cent for the month. The fall in inflation in December was mainly due to the decline in administered prices at the end of the year, which was only partially offset by rising fuel prices. Underlying inflation remained subdued, with demand-sensitive and sticky price inflation both decreasing in December.

Positive cost-side and demand factors may have also contributed to the subdued underlying inflation in the past months. Agricultural producer prices fell by 14.6 per cent year-on-year in November 2013, while domestic industrial sales prices decreased by 0.4 per cent. In line with movements in global crude oil prices, domestic fuel prices declined again, after rising in December. Retail trade data suggest that consumption demand increased gradually over the past months, but retail sales still remain considerably below pre-crisis levels. Consequently, the domestic demand environment may continue to have a disinflationary impact.

The December inflation figure remains slightly below the MNB's December projection and analysts' expectations. The discrepancy stems mainly from lower-than-expected tradables inflation. Positive developments in import prices, the stable forint exchange rate in recent months and weak demand may all have contributed to the low price dynamics of tradables. As service prices are typically changed at the beginning of the year, the January 2014 inflation figure will provide relevant information on developments in underlying inflation.

In the December projection, economic activity picks up gradually, increasingly driven by domestic demand — mainly investment activity in the short run — alongside exports. According to the December projection, growth should continue to accelerate in year-on-year terms in the fourth quarter of 2013, but may be slower relative to the third quarter of 2013.

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.

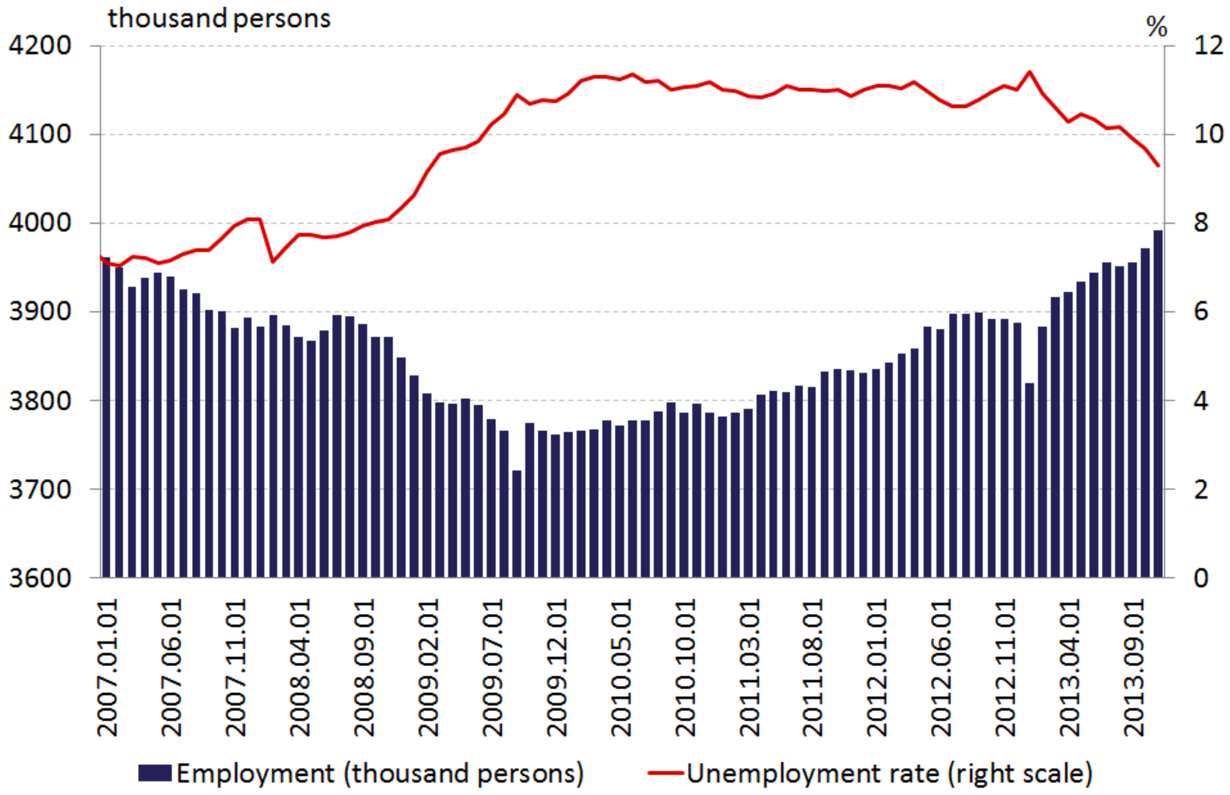
Source: MNB.

The latest measures of economic activity were in line with December projection. In November 2013, industrial output grew by 3.5 per cent, construction output by 18.9 per cent and retail sales by 4.9 per cent in a year-on-year comparison. Sectoral output data suggest that annual GDP growth may have continued to increase, in line with the projection. On the other hand, seasonally adjusted level of industrial output fell slightly in October and November, pointing to more subdued quarterly GDP dynamics for late 2013. Construction output and retail trade turnover continued to rise relative to the previous month, in line with expectations. Sectoral confidence indicators improved further in recent months. New industrial orders, which display greater volatility, fell back in October and November, following a sharp increase in previous months.

Expenditure side developments confirmed the key messages from the December projection. Preliminary data indicated that the volume of retail trade expanded in November, suggesting continued gradual growth in household consumption. Rising sales of non-food items, together with fuel and food items, also contributed to this growth, which may reflect a gradual increase in household consumption. The pick-up in household consumption may also be driven by improving consumer confidence, in addition to rising real wages.

Preliminary data indicated that the trade surplus remained high in November. The trade surplus for the first eleven months of the year amounted to EUR 2 billion, compared to EUR 1.9 billion in the same period of 2012. Based on these factors, the contribution of net exports to economic growth may have remained strong in the fourth quarter of 2013.

Chart 3: Labour market indicators



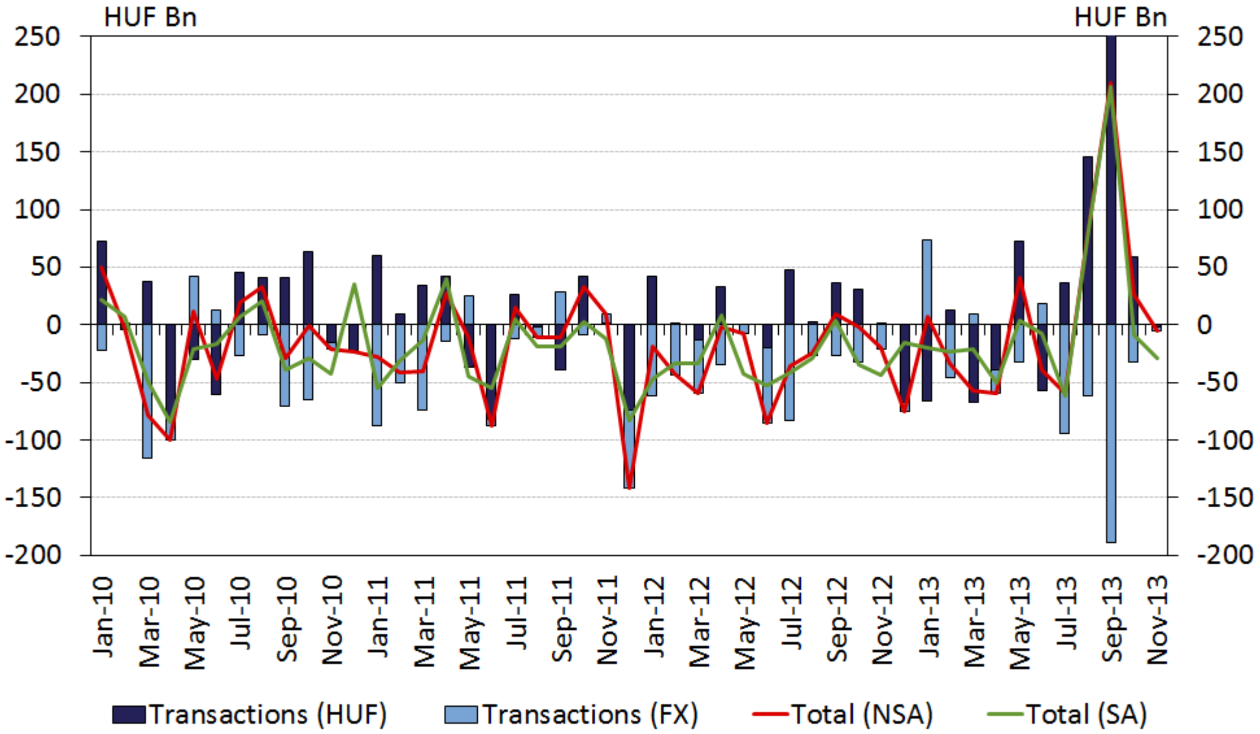
Source: CSO.

According to 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 November Labour Force Survey, the number of whole-economy employees in the 15–74 age bracket amounted to 4,004,000, up 3 per cent on the same period a year earlier. Based on the seasonally adjusted data, employment continued to increase, while the number of unemployed fell markedly relative to the previous month. The unemployment rate stood at 9.3 per cent in November.

Private sector wage data for October showed an increase in the rate of gross average earnings growth, with private sector earnings rising by 5.1 per cent relative to the same period a year earlier. However, October wage data provide little information, as regular wages typically change at the start of the year, while large bonuses are generally paid out in the last two months of the year. The changing seasonality of wages may have also contributed to the pick-up in wage growth in October, which has rendered monthly changes in wages more volatile in recent years, thereby making it more difficult to assess underlying developments.

In November, outstanding bank lending to the corporate sector fell by HUF 5.6 billion (on a transaction basis) after rising in previous months. The decline reflected a HUF 2.3 billion decline in forint loans and a HUF 3.3 billion decline in foreign currency loans. Average interest rates on both smaller and larger loans decreased in November.

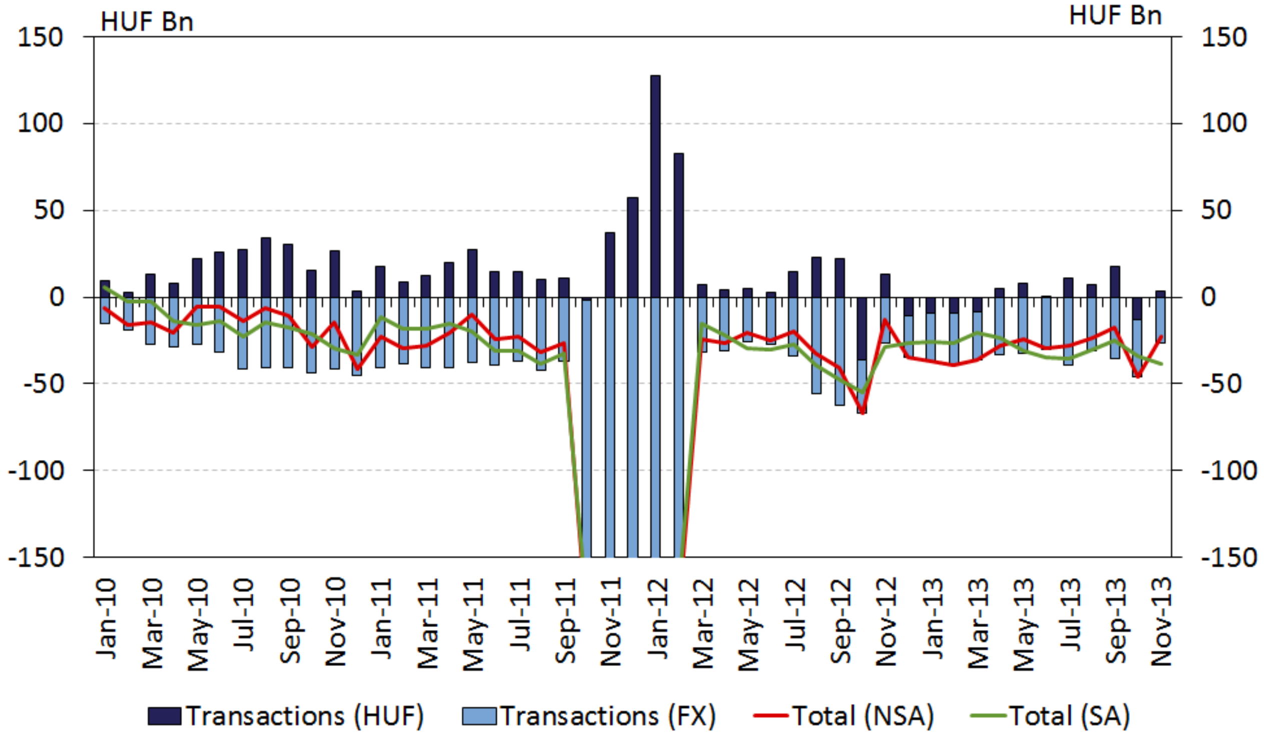
Chart 1: Corporate loan portfolio



Source: MNB.

The decline in household lending continued in November. The stock of household loans fell by HUF 23 billion, and thus showed a smaller decline than the average of previous months, as a result of foreign currency loans dropping by HUF 27 billion and forint loans rising by HUF 4 billion. The average interest rate on newly disbursed housing loans changed very little (decreasing slightly) while that on home equity loans returned to its previous level following a marked fall in October.

Chart 5: Household loan portfolio



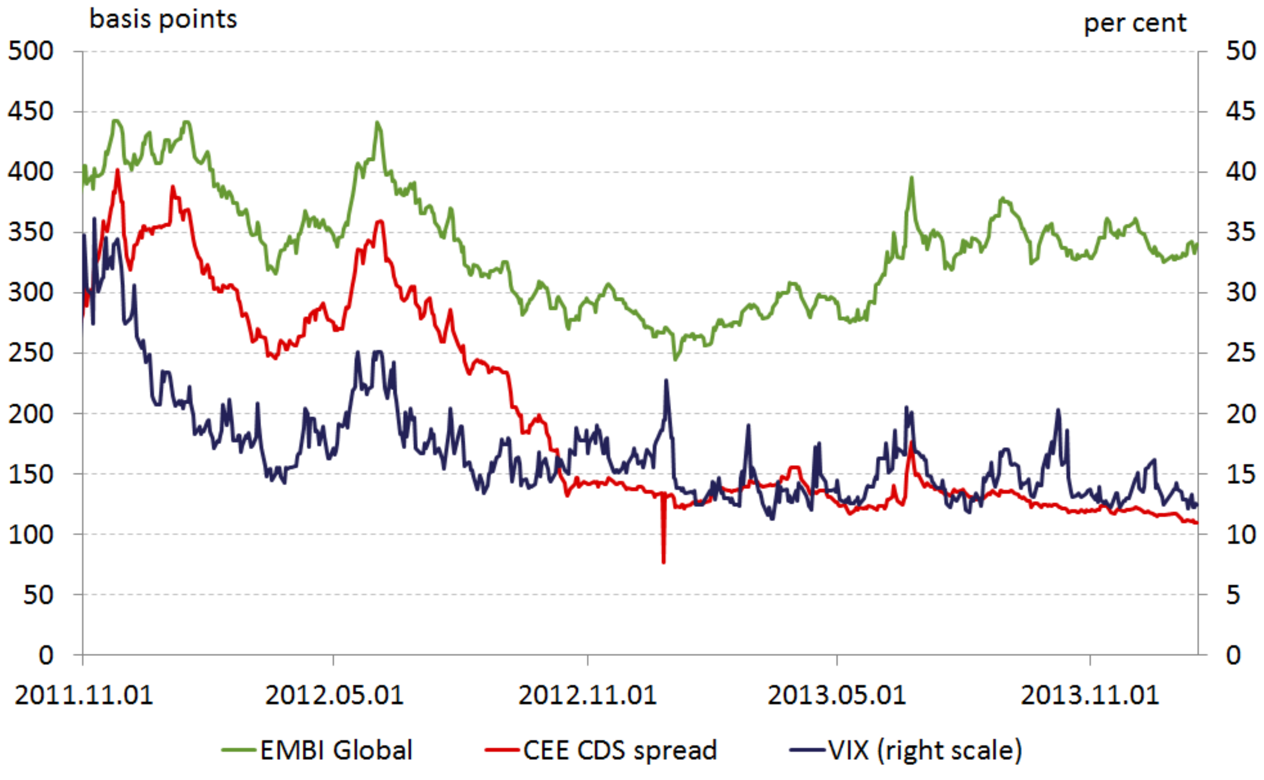
Source: MNB.

Financial markets

Money and capital markets saw calm trading until the end of the week preceding the January interest rate decision,[1] as market participants continued to focus on the monetary policies of developed economy central banks and incoming macroeconomic data. At its December policy meeting, the Federal Open Market Committee (FOMC) decided on a reduction in the pace of the Fed's asset purchase programme (QE3), but market reaction was subdued, despite the surprise decision. While the US macroeconomic data released early in the period elapsed since December's interest rate decision were better than expected, the change in the weaker-than-expected nonfarm payroll employment figure released towards the end of the period only had a temporary impact on market expectations regarding the Fed's decision to taper its asset purchases at its January meeting.

In line with expectations, decision-makers left monetary conditions unchanged at the policy meetings of the European Central Bank (ECB), the Bank of England and the Bank of Japan. In December, euro-area inflation fell less than expected after rising in November. The ECB expects inflation to remain low persistently and does not deem the risks of deflation to be threatening.

Chart 6: Major international risk indicators



Source: Thomson Reuters.

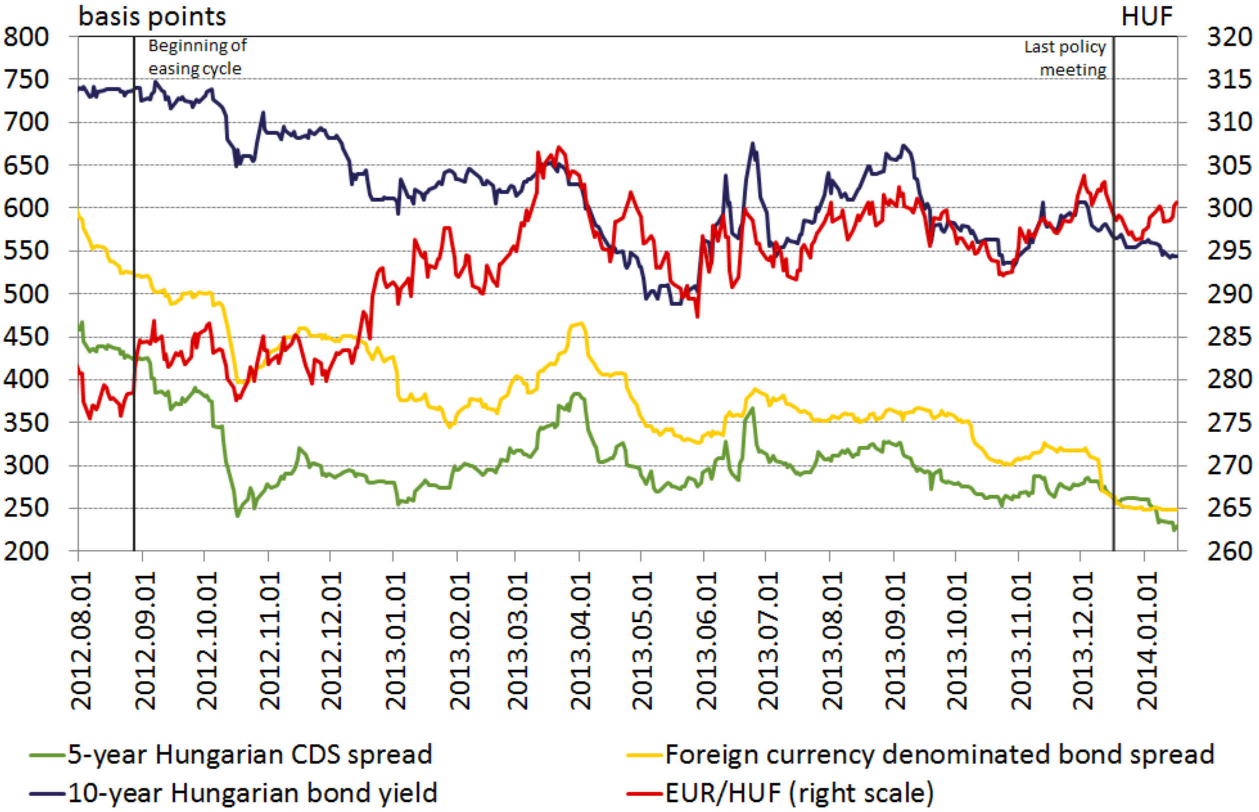
[1] The chapter on financial markets focuses on the period between the December and January interest rate decision; the data collection period was closed on 17 January, the Friday preceding the interest rate decision.

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 US stock market, fell, the EMBI Global, an indicator of emerging markets' bond market developments, remained unchanged. Developed market stock market indices rose to new historical highs. In the wake of the Fed's interest rate decision, the US dollar began to strengthen, appreciating by one per cent against the euro. Yields on ten-year benchmark US government bonds rose above 3 per cent, but fell back to their initial level by the end of the period. Economic stabilisation in the peripheral countries was coupled with a marked decline in their long-term yields. Movements in yields on ten-year government bonds in Central and Eastern European countries were mixed: Polish and Czech yields rose, while Romanian and Hungarian yields shifted downwards.

In the period since December's interest rate decision, few domestic market-moving events occurred. They include news of the rescue package for foreign currency debtors, the Bank's guidance and comments by certain decision-makers on interest rate policy. On the whole, Hungarian financial market sentiment was mainly shaped by international developments.

Hungarian market developments were essentially positive. Following appreciation of one per cent at the beginning of the period, the forint began losing value in January and closed the period nearly half a per cent lower compared to the beginning of the period. This performance put Hungary among the middle-ranking countries in the region. The Hungarian five-year US dollar-denominated CDS spread narrowed markedly, by 30 basis points in the period under review, the spread on USD bonds shrank by 20-40 basis points, while the spread on euro-denominated bonds remained essentially unchanged. Issues of forint-denominated government securities in the primary market were successful overall, with strong demand for both short and long-term papers. The secondary market yield on three-month discount Treasury bills dropped by over ten basis points by the end of the period, while the ten-year benchmark yield fell by 25 basis points after fluctuating narrowly to 5.5 per cent by the end of the period. As a result, the steepness of the yield curve for government securities decreased on the whole.

Chart 7: Domestic risk indicators



Source: Thomson Reuters.