Macroeconomic and financial market developments

March 2014

Background material
to the abridged minutes of the
Monetary Council meeting
25 March 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

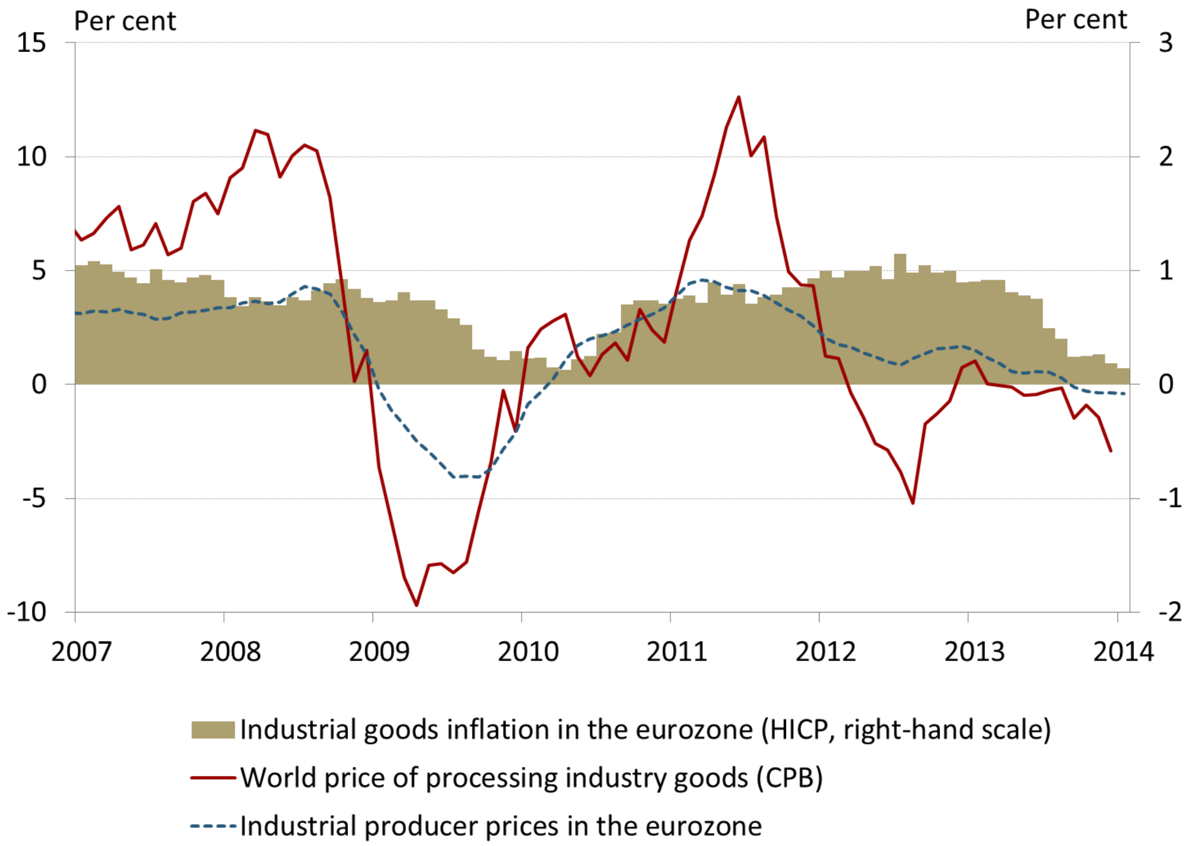
Macroeconomic developments

The global economy

The recovery in the global economy continued in the fourth quarter of 2013. The growth environment diverged on different paths for the developed and emerging economies. Activity in emerging market economies which had previously shown rapid growth slowed down in the final months of 2013, in contrast with the advanced economies where signs of an upturn in economic activity became increasingly evident. Based on the latest indicators of activity, these divergent trends continued in the early months of 2014.

The euro-area economy recovered from recession in the second half of 2013. Indicators of activity for January signal strengthening growth, along with expansion in industrial production and retail trade. The output of Germany, Hungary’s most important trading partner, continued to grow, and the dynamics of German industrial orders also picked up.

Chart 1: Industrial producer prices and tradables inflation in the euro area; and the world market price of manufacturing goods



Inflationary pressures from the world market have remained weak in recent months. Declining commodity prices, coupled with modest growth in the global economy, are pushing inflation down. As a result, inflation rates in the world's major economies continue to remain below target. Movements in the prices of industrial commodities and unprocessed foods continue to be moderate. Growth in the world price of manufactured goods remain subdued.

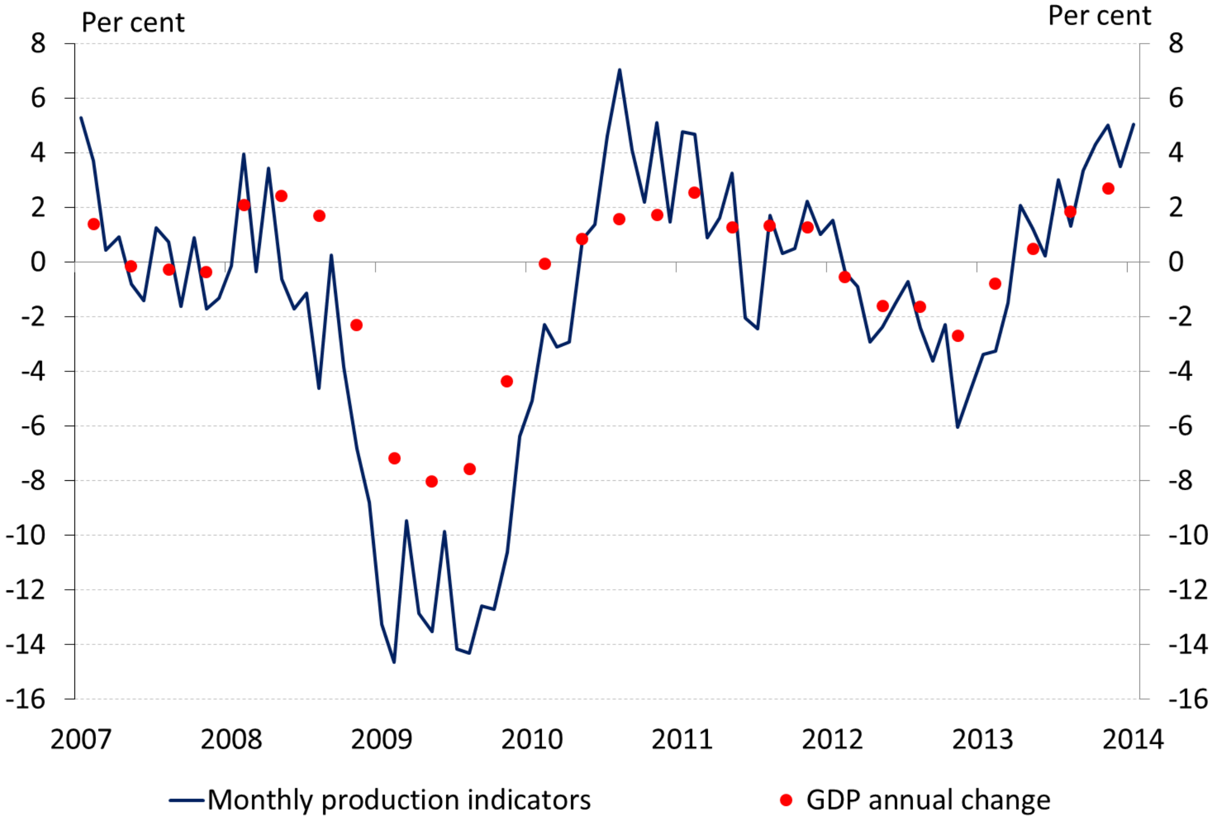
Domestic real economic and labour market developments

Domestic economic growth continued in 2014 Q1. The Hungarian economy picked up gradually during 2013, with gross domestic product growing by 2.7 per cent in the fourth quarter compaired to the same period a year earlier. This rate of growth was consistent with the projection in the December issue of the Bank's *Quarterly Report on Inflation*. Based on the production measures and the forward-looking indicators for January, economic growth may have remained elevated in early 2014. Output trends in several sectors of the economy turned around in the course of 2013. In January 2014, output grew in a wide range of economic sectors.

The Bank expects the economy to grow steadily in the period ahead, with exports and domestic demand both likely to expand. This is indicated by the fact that the output of both the export sector and sectors producing for the domestic market grew in January.

Industrial production rose by 6.1 per cent relative to a year earlier and by 2.1 per cent relative to the previous month. Output increased across a wide range manufacturing industries in January. As seen last year, the performance of the vehicle industry accounted for the greater part of the expansion at the beginning of the year. The favourable demand environment suggests that performance will remain similar in the coming months. Although the volume of new industrial orders fell by 3.3 per cent in January relative to a year earlier, the average growth rate of the last three months was 13.9 per cent. In January, the output of the energy sector fell due to the mild weather, temporarily cushioning the increase in industrial production. Goods exports continued to rise in January, in line with developments in the industry, driven mainly by the vehicle industry exports. The seasonally adjusted level of imports, however, stagnated in January.

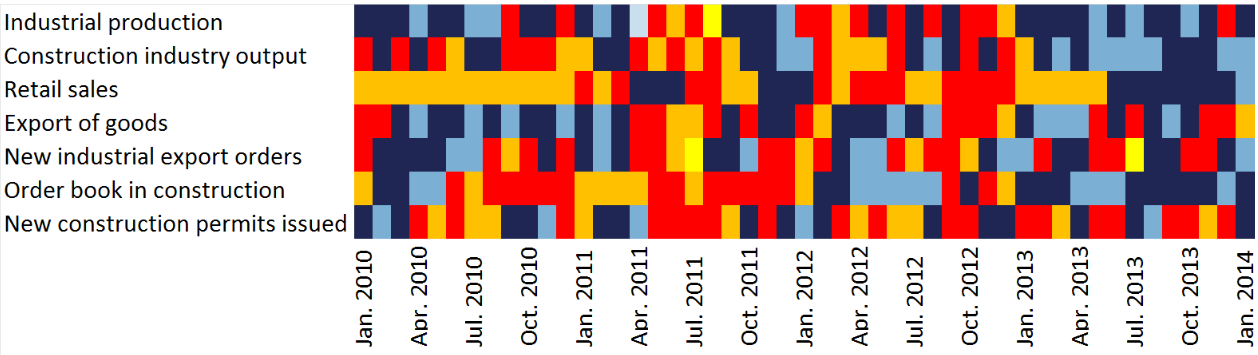
Chart 2: Monthly production indicators and annual change in GDP*



* 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.

Construction output continued to grow in January (+15.9 per cent year on year), with divergent trends of private and state projects continuing from last year. While private sector investment remained subdued, government investment activity mainly in infrastructure, financed from EU funding, continued to be robust. Although the mild weather in January may also have been reflected in the favourable production data, the sharp increase in industrial orders points to vigorous growth in production in the coming months. Contracts for construction were 66.7 per cent higher than a year earlier. In addition, new building permits for dwellings increased in January reversing a decline over the past several months, suggesting that activity in the housing market may stabilise. Based on the favourable data for construction, building construction may have risen significantly in early 2014.

*Chart 3: 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: dark blue = grows above the five-year average, at an accelerating rate; blue = grows above the average, at a slowing rate; light blue = grows below the average, at an accelerating rate; yellow = grows below the average, at a slowing rate; orange = falls at a slowing rate; red = falls at an accelerating rate.

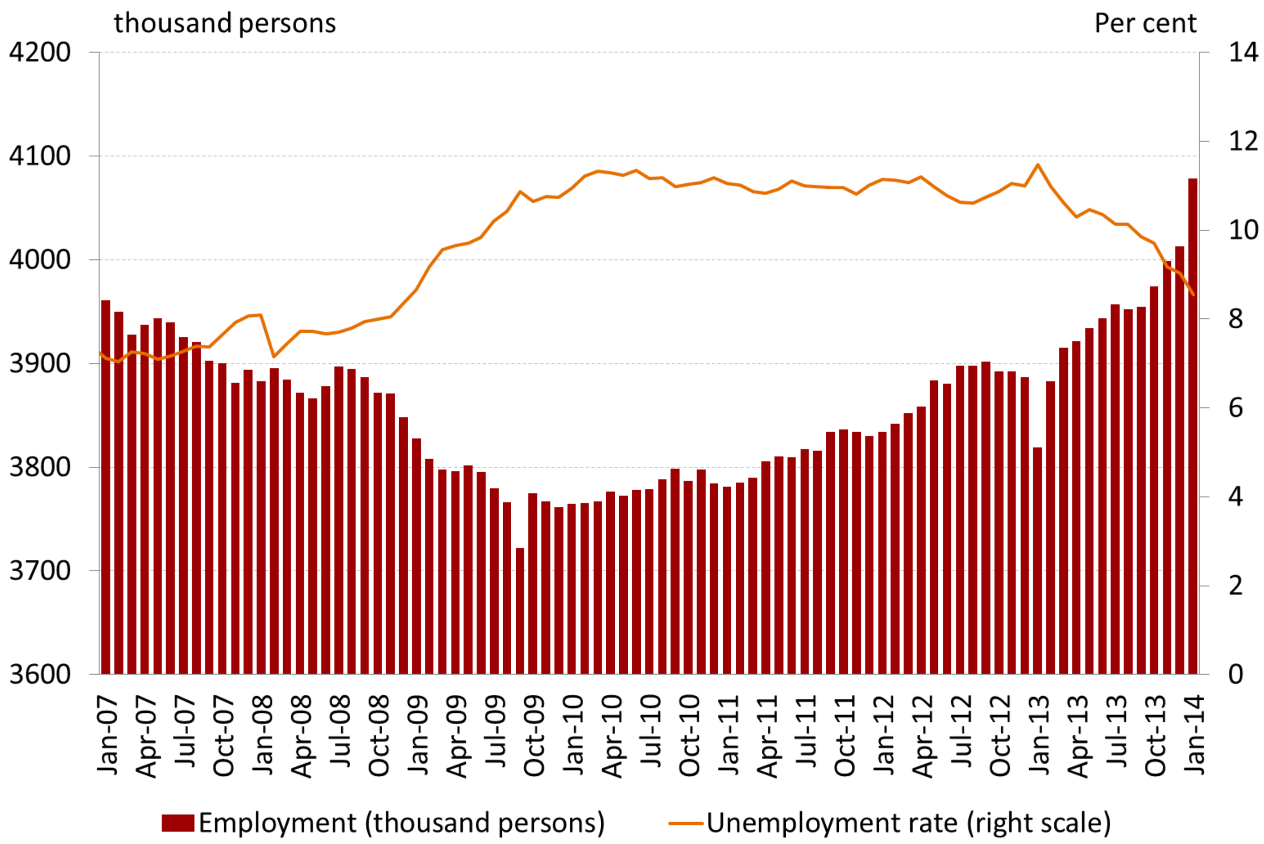
The gradual increase in consumption demand may have continued in early 2014, with retail sales recording significant growth. According to preliminary data, the volume of retail sales rose by 3.9 per cent in January (year on year) and by 1.1 per cent relative to December 2013.[1] Retails sales rose gradually last year, with a continued increase in consumption expected from post-crisis levels this year. Significantly rising household real income due to historically low inflation underpins a further increase in household consumption. However, the recovery is still expected to be only modest, reflecting the strong presence of precautionary savings and households' balance sheet adjustment.

According to Labour Force Survey data, the number of employees in the total economy continued to rise in January. The unemployment rate fell further to 8.6 per cent. The increase in employment may have mainly reflected the effect of public labour programmes during the winter. Detailed data are available for 2013 Q4. The number of employees in the government sector increased significantly in the final quarter of last year, and private sector employment also rose. Employment in manufacturing rose, in contrast to a slight decline in services employment compaired to the previous quarter.

[1] The Central Statistical Office released detailed January retail sales data after the 25 March interest rate decision, which showed a significantly stronger rise compared to the preliminary estimate. The change in the method of recording turnover in tobacco products in the detailed release accounted for most of the difference. Whereas prior to July 2013 the CSO estimated tobacco turnover on a representative sample, following the introduction of tobacco shops it switched to the data supply by Nemzeti Dohánykereskedelmi Nonprofit Zrt., which provides full cover of legal tobacco sales. Due to this methodological change, data for the period before and after July 2013 are not directly comparable. Adjusted for the change in tobacco turnover, retail sales rose by 2.7 per cent in January relative to the same period of the previous year.

According to data released by the National Employment Service, the number of new, non-subsidised jobs rose significantly in February relative to previous months, confirming a continuous improvement in corporate demand for labour. The number of new jobs fell in previous months, but the February data represented a return to autumn levels.

Chart 4: Labour market indicators



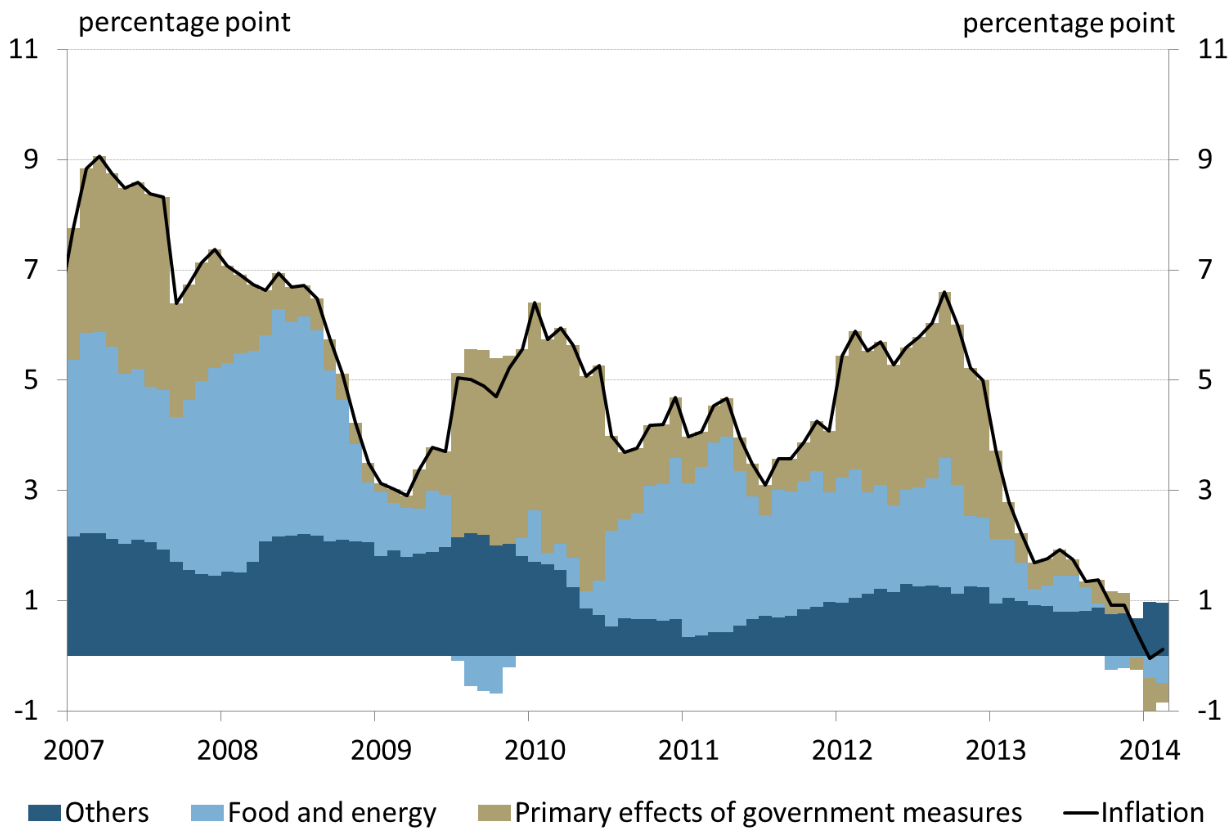
Inflation and wages

Private sector earnings growth was moderate in 2013 as a whole, with gross average earnings rising by 3.6 per cent. In December 2013, gross average earnings in the private sector grew by 0.5 per cent. Last year (as in 2012), wage growth across the economy was much more mixed than in previous years. Wage growth was divergent in the large sectors. While in market services earnings growth was moderate throughout the year as a whole, earnings growth was steady in manufacturing, and only slowed in the final month of the year.

In February 2014, the consumer price index stood at 0.1 per cent, with core inflation at 2.8 per cent and core inflation excluding the effect of indirect taxes at 1.6 per cent. Consumer price inflation rose by 0.1 percentage point and core inflation fell by 0.6 percentage points relative to the previous month. The decline in core inflation mainly reflected the moderation in alcohol and tobacco price inflation due to a base effect and the decline in market services prices. However, at the overall level this was offset by the drop-out of the reduction in regulated energy prices at the beginning of last year from the base.

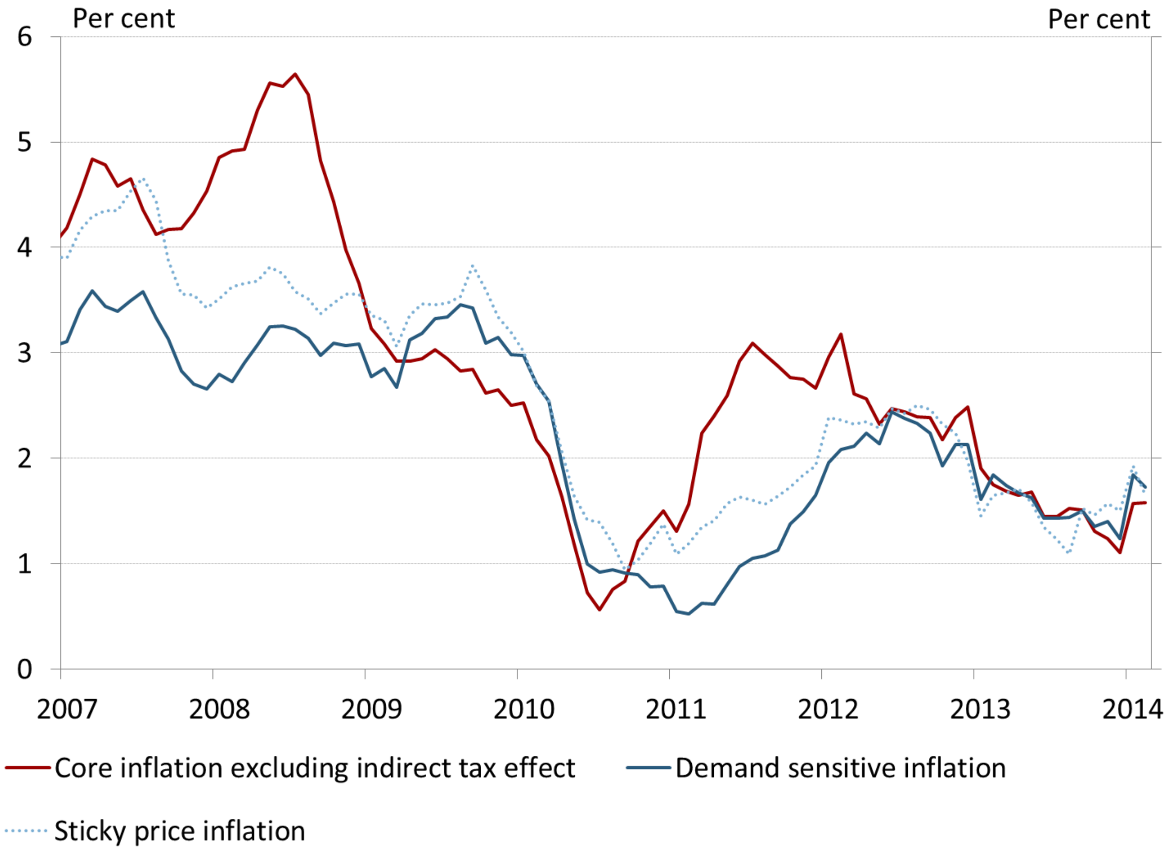
Inflation slowed further in the past quarter and remained at a historically low level, well below the 3 per cent inflation target. Downward cost pressures on prices, the subdued demand environment, the gradual adjustment of expectations and the reduction in regulated energy prices may have all contributed to the development of a low inflation environment. The latest inflation data were lower than the projection in the December *Report*. This difference partly reflects cost-side factors, favourable developments in commodity and oil prices in particular. In addition, moderate tradables inflation also contributed to the difference.

Chart 5: Decomposition of the consumer price index



The measures capturing developments in underlying inflation rose slightly at the beginning of the year, in part reflecting the base effect of subdued movements in prices last January. In February, the levels of underlying inflation measures partly reversed. The low level of underlying inflation measures continues to point to a moderate inflation environment, in line with the factors discussed above. Core inflation excluding the effect of indirect taxes is likely to begin rising from its current low level from the second quarter of 2014, as domestic demand picks up gradually and the weaker exchange rate since the beginning of the year passes through into prices.

Chart 6: Measures of underlying inflation

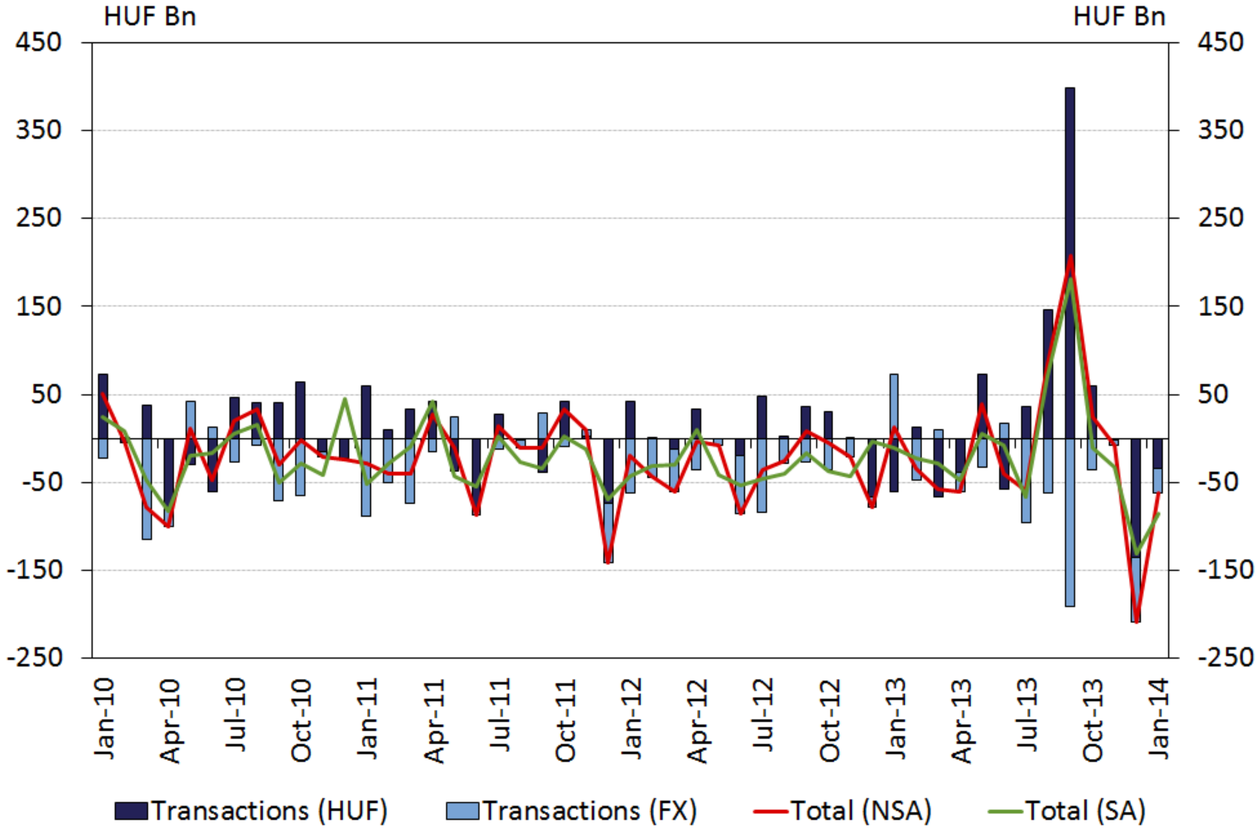


Favourable developments in costs and demand may both have contributed to subdued movements in underlying inflation in recent months. In January 2014, agricultural producer prices fell by 13.4 per cent year on year. Domestic sales prices of firms producing for the domestic market rose by 1.2 per cent in January 2014 relative to the same period of the previous year. Fuel prices fell at the beginning of the year, mainly reflecting the decline in crude oil prices in US dollar terms. However, fuel prices rose once again in February, reflecting the depreciation of the forint exchange rate. According to retail sales data, consumption demand may have picked up gradually in recent months, but the volume of retail sales continues to be significantly below levels seen during the years prior to the crisis. Consequently, the domestic demand environment is likely to continue to have a disinflationary impact.

Domestic credit

In January 2014, net borrowing by non-financial corporations amounted to HUF -63 billion, and consequently the sector had a net repayer position vis-à-vis credit institutions. Repayments exceeded disbursements by HUF 34 billion in forint terms and by HUF 29 billion in foreign currency terms, affecting both short and long-term loans. The annual decline in outstanding loans to non-financial corporations in transaction terms was around 2.5 per cent. In January, the average interest rate on small-value forint loans was broadly unchanged relative to December 2013. The average interest rate on larger-value forint loans continued to fall, albeit at a slower pace.

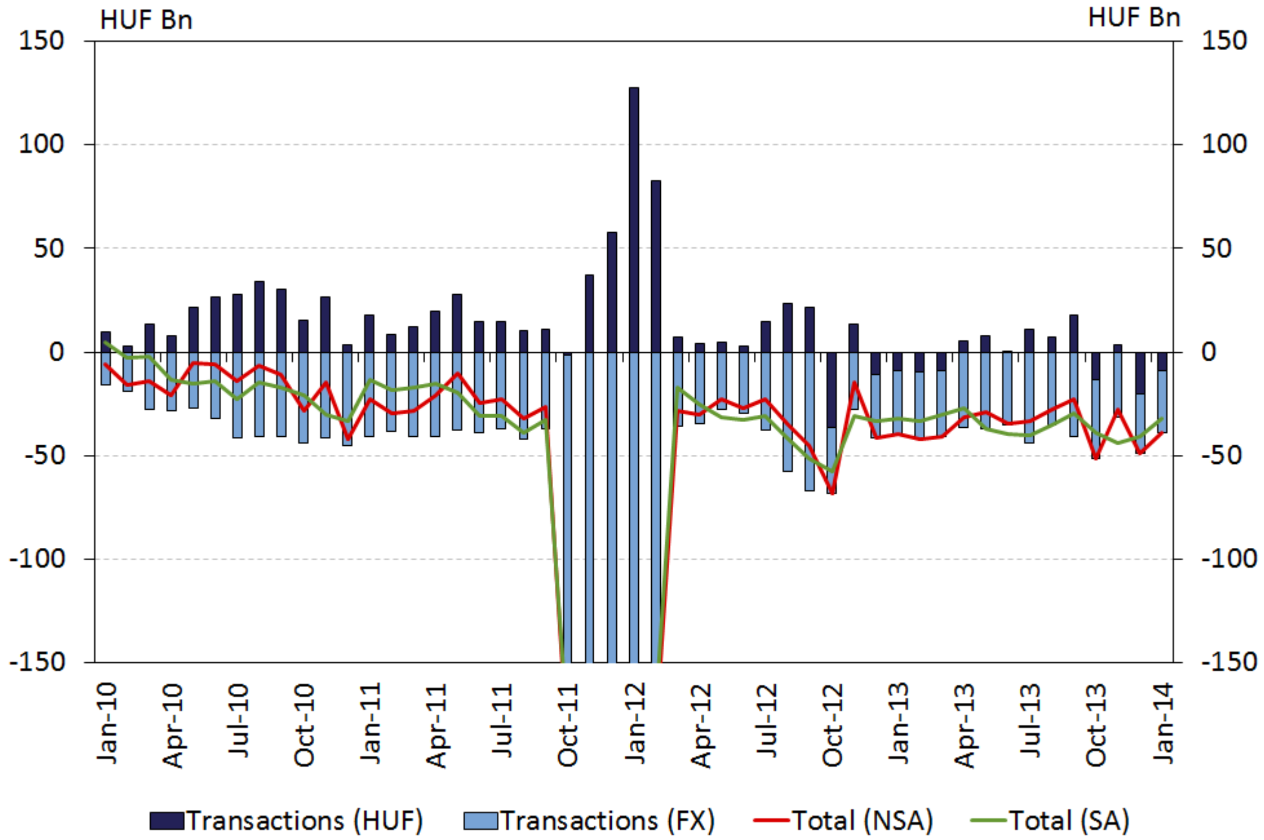
Chart 7: Corporate sector loan portfolio



In January, net borrowing by households from credit institutions amounted to HUF -39 billion. Households repaid both forint and foreign currency loans in net terms during the month: repayments of the former amounted to HUF 30 billion and those of the latter to HUF 9 billion. The annual decline in outstanding loans to the sector in transaction terms remained at 5.9 per cent. The average interest rate on new housing loans continued to fall at an accelerating pace in

January, while the average interest rate on home equity loans was largely unchanged relative to December.

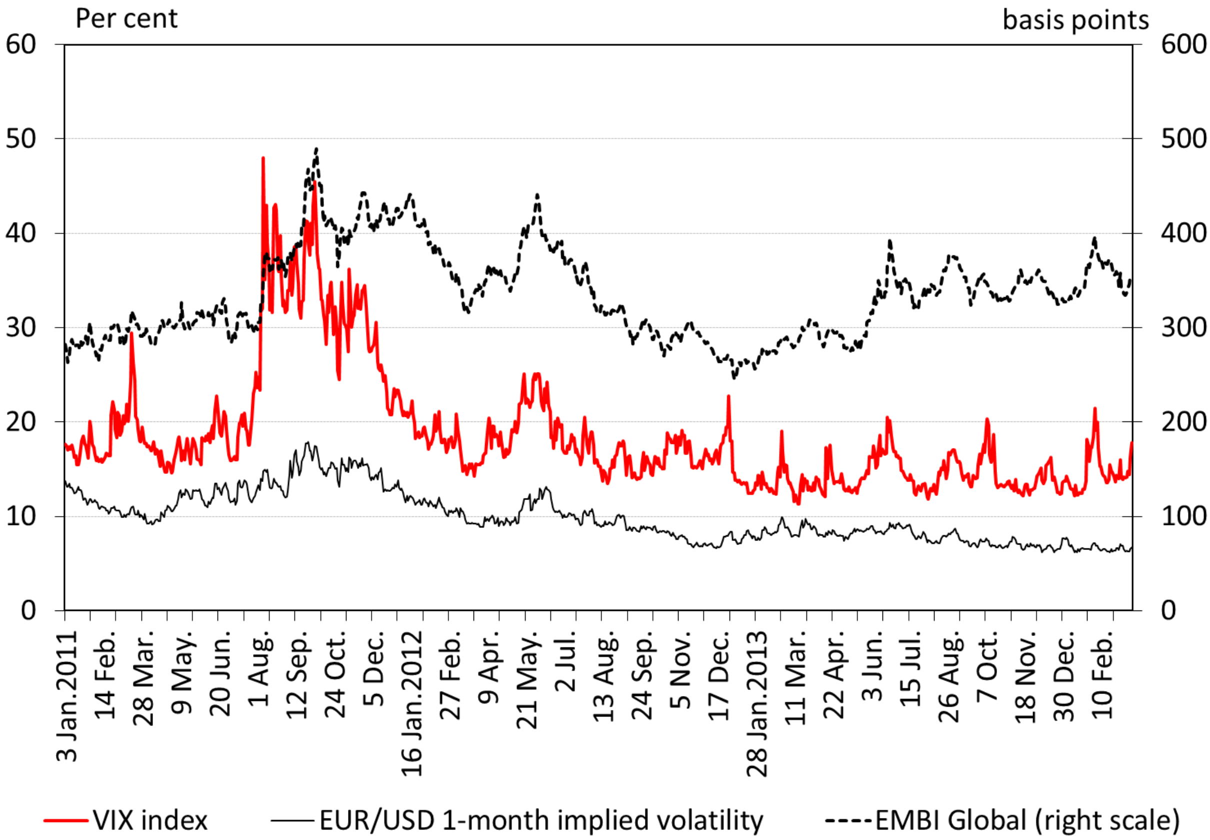
Chart 8: Household sector loan portfolio



Financial markets

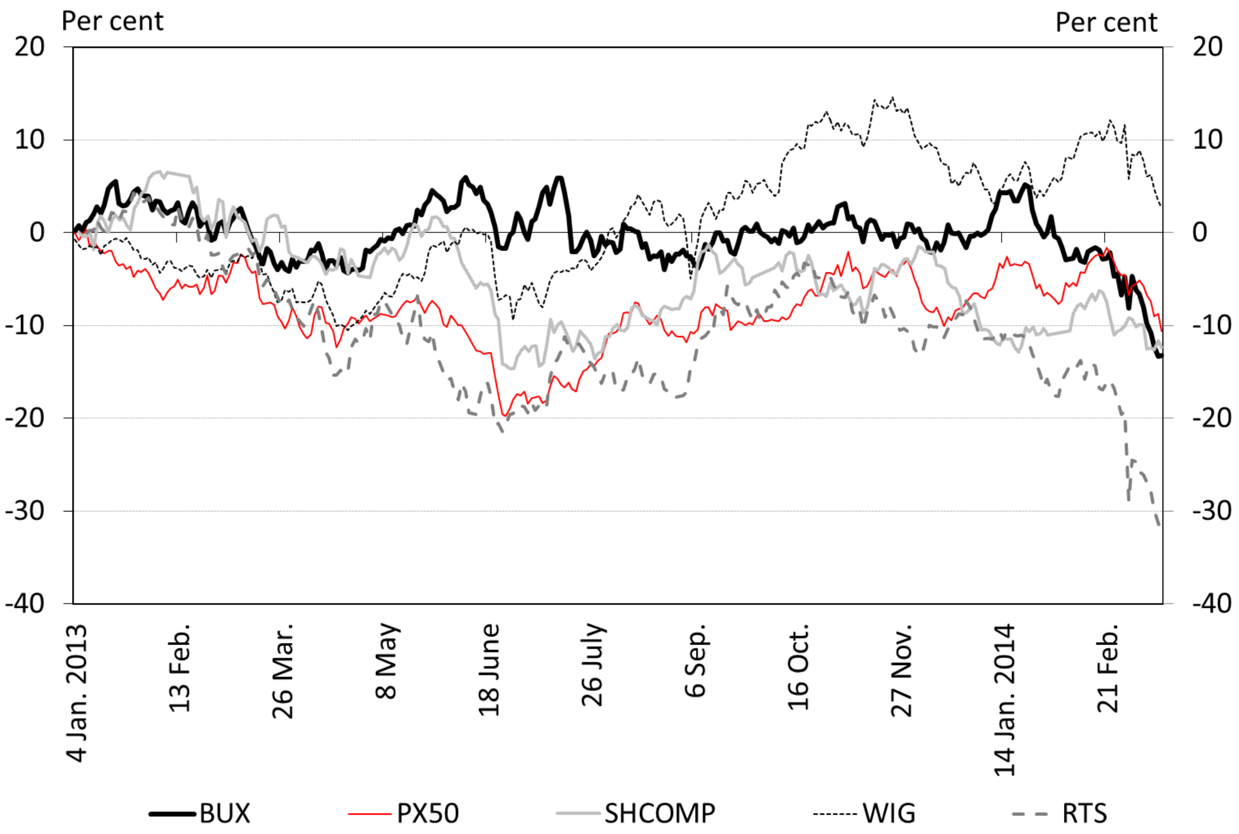
In the period since the Council's February interest rate decision, conditions in financial markets have been volatile; market participants focused on concerns about growth in emerging market economies and geopolitical tensions. Consequently, equity markets relatively underperformed bond markets as sentiment turned increasingly bearish. This was also reflected in developments in risk indicators: while the VIX index, a measure of the implied volatility of the US equity market, rose slightly, the EMBI Global, an indicator of emerging countries' bond market developments, fell. Movements in money and capital markets were mainly influenced by developments in Ukraine and increasing political tensions between Russia and Western states, in addition to news from the world's leading central banks. An increasing number of market analyses dealt with the exposure of emerging countries, and particularly Central and Eastern Europe, to Russia and Ukraine, partly in terms of their foreign trade relationships and their dependence on Russian natural gas imports. Of the currencies of Central and Eastern Europe, the Czech koruna and the Romanian leu moved relatively little in the past month, while the Polish zloty and the Hungarian forint depreciated throughout most of the period, before reversing a large part of their 1.5–2 per cent losses by the very end of the period, as tensions between Russia and Ukraine abated. Concerns over a slowdown in the global economy have been heightened by news of weaker-than-expected data on the Chinese economy, which may also have contributed to volatility in global sentiment, in addition to the situation in Ukraine. The performance of developed market equity indices was mixed: markets in Europe and Japan underperformed relative to US markets.

Chart 9: Main international risk indicators



The ECB left its key policy rate unchanged, maintaining its forward guidance. The President noted that the ECB currently perceived no direct deflationary threat in the euro area. In March, the Fed continued to taper its asset purchases started in December; based on the Fed's communications, markets expect that the first interest rate increase may come earlier. The Bank of England signalled that the fall in the unemployment rate to 7 per cent earlier than expected did not automatically imply that a tightening cycle would soon begin. In Russia, at its extraordinary meeting the central bank raised interest rates by 150 basis points to 7 per cent, referring to the sharp depreciation of the rouble since the beginning of the year. In New Zealand and Brazil, official interest rates were raised by 25 basis points. The US dollar appreciated by 1.5 per cent against the euro, reaching the EUR/USD 1.3950 level. The Swiss franc and the Japanese yen, traditionally seen as safe haven currencies, appreciated against the US dollar. Long-term yields in advanced countries continued to decline, driven by forward guidance from central banks. Negative sentiment had less impact on long-term yields in periphery countries, with yields falling slightly. Yields on government securities in emerging economies of the region also fell after rising strongly at the end of February. By the end of the period, ten-year yields on Czech and Romanian government bonds fell by 8–10 basis points and those on Polish and Hungarian government bonds more strongly, by 20–25 basis points.

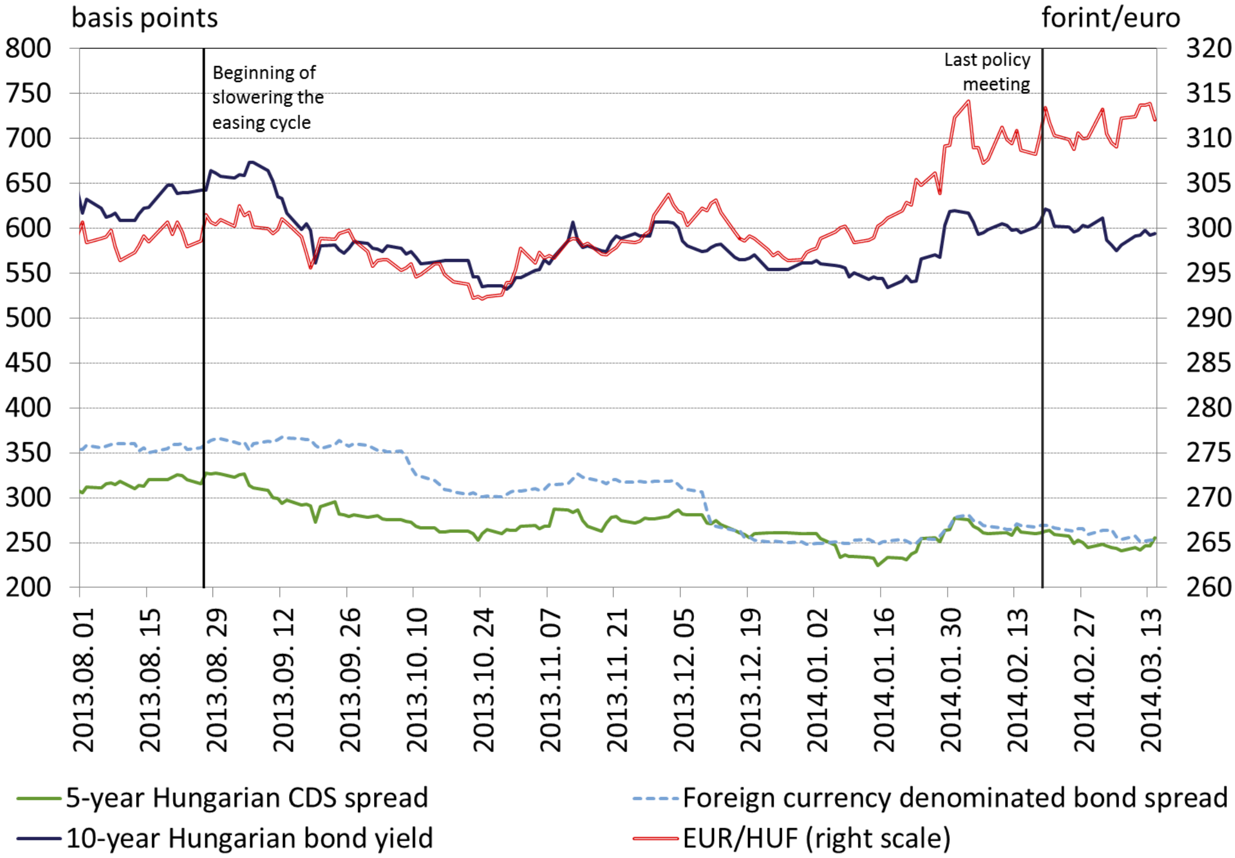
Chart 10: Equity indices in selected emerging markets



In the period since February's interest rate decision, relatively few domestic market-moving events occurred. Of these, the decision by the Constitutional Court about foreign currency loans and the statements by central bank decision-makers on future interest rate policy deserve special mention. On balance, domestic financial market sentiment was driven mainly by international rather than by domestic news. The BUX index declined by some 10 per cent over the past month, while equity markets in the region fell by 3–6 per cent.

Hungarian foreign exchange market developments and risk indicators showed a mixed picture. The five-year CDS spread moved narrowly, virtually stagnating in the period, in line with movements in other indicators in the region. Spreads on euro and US dollar-denominated bonds dropped slightly, down by 10–20 basis points. The yield on the ten-year forint-denominated government bond declined by 20 basis points by the end of the period. At the same time, the forint fluctuated within a range of EUR/HUF 308–315 against the euro, associated with high volatility.

Chart 11: Domestic risk indicators



On balance, the forint depreciated by 0.5 per cent in the period, showing average performance in the region. The skewness measure, indicating short-term expectations on the exchange rate, first rising slightly, then begin falling, but still remained above levels seen in most of 2013. Non-resident holdings of Hungarian government securities declined by HUF 120 billion until early March, and then adjusted upwards strongly towards the end of the period, taking the overall decline to HUF 25 billion.

Primary issues in the forint government securities market were met with strong demand, as the issuer was able to raise the quantities of both short and long-term securities on offer; however, average yields rose sharply in the turbulent conditions at the end of February, before easing back by the end of the period. Over the period as a whole, short-term yields in the secondary market of forint government securities fell by 15–20 basis points and long-term yields by 5–20 basis points.

Box: Assessment of the foreign currency bond issue in March

On 18 March 2014, the Government Debt Management Agency issued five and ten-year US dollar-denominated government bonds. Through the issue, oversubscribed significantly by five times, the Government raised a total of USD 3 billion at yields of 4.14 per cent (five-year bond) and 5.55 per cent (ten-year bond). These were equal to spreads of 260 basis points and 287 basis points, respectively, over yields on US Treasury bonds of the same maturity, and were lower than the spreads on domestic issues in recent years. The lower domestic risk premium also contributed to reaching a lower yield level than in previous years. This spread was in line with experience with dollar-denominated bond issues in other countries in the region (Romania and Slovenia) recently. With the dollar bond issues in March, a large part of the dollar issue programme planned for this year was completed.