Macroeconomic and financial market developments

August 2014

Background material
to the abridged minutes of the
Monetary Council meeting
26 August 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

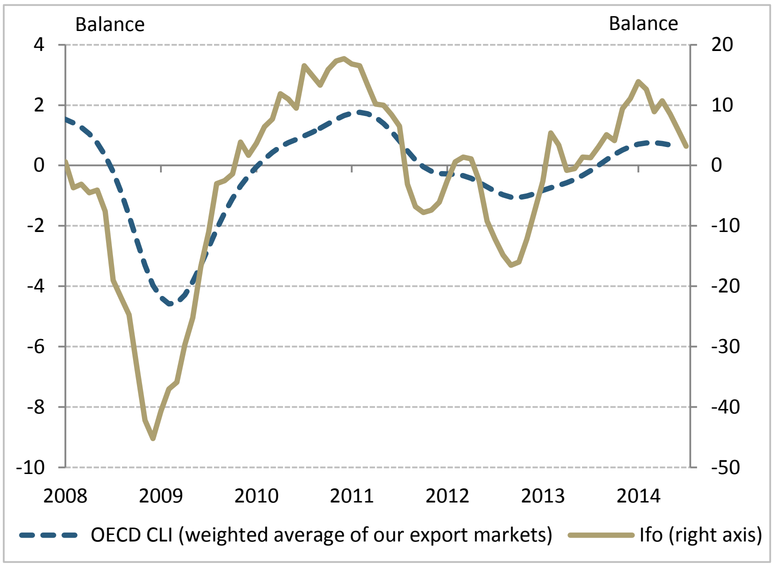
1 Macroeconomic developments

1.1 The global economy

Economic growth in Hungary's export markets is gradually picking up. In recent months, the euro area has continued to recover from recession, although at a slow pace. However, second-quarter data turned out to be weaker than expected. The outlook for growth in emerging regions deteriorated, mainly as a result of the conflict between Ukraine and Russia. Heightened geopolitical tensions may also adversely affect the performance of developed countries through the effect of economic sanctions. Inflationary pressures from the world market have remained muted in recent months.

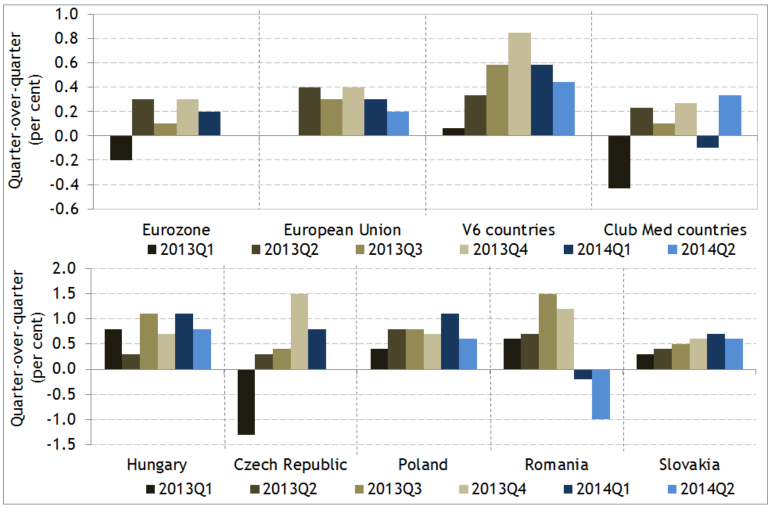
Slow growth in the world economy continued in the second quarter of 2014. Growth moved on different paths for the developed and emerging economies. Activity in emerging market economies which had previously shown rapid growth slowed down in the first half, in contrast with advanced economies where growth continued, but its pace was somewhat slower in the second quarter than previously expected. This partly reflected the economic slowdown due to heightened geopolitical risks related to the conflict between Ukraine and Russia, which might even intensify in the second half as economic sanctions are imposed.

Chart 1 Indicators of activity in Hungary's export markets



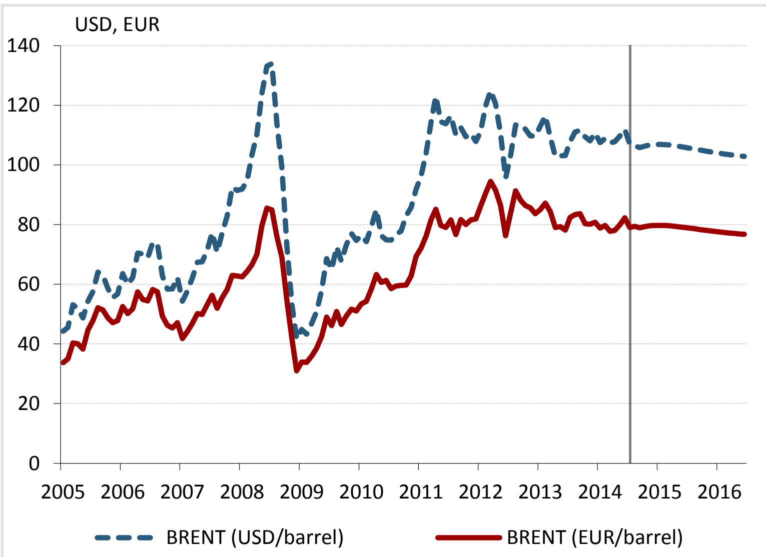
In the second quarter of 2014, growth in the euro-area economy continued to be weak. Forward-looking indicators suggested a gradual slowdown in activity in recent months. This may reflect the deterioration in the geopolitical situation; the increase in uncertainty and the gradually widening scope of mutual economic sanctions, which may lead to a slowdown in economic activity. In line with this, second-quarter data showed that growth was slightly slower than expected. The industrial output of Germany, Hungary's most important trading partner, has been flat in recent months and the volume of new German industrial orders has fallen slightly (Chart 1).

Chart 2 Growth in countries of the EU



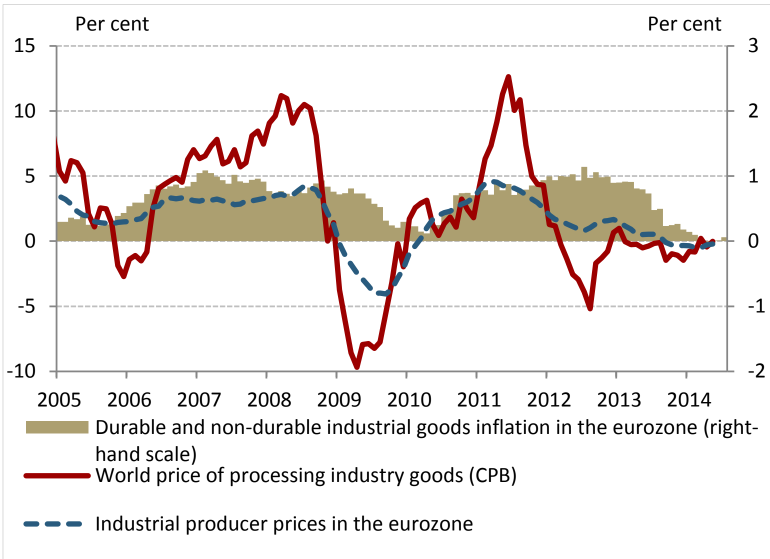
Weaker-than-expected economic data were released in France and Italy, in addition to data showing a slowdown in Germany. However, the performance of our region was positive in the second quarter; the escalation of the conflict between Ukraine and Russia and the slowdown in Europe had only limited impact on growth in the Central and Eastern European region (Chart 2).

Chart 3 World market price of Brent crude oil



Inflationary pressures from the world market remain subdued. Declining commodity prices, combined with a slowly growing global economy, are exerting downward pressure on inflation. As a result, inflation rates remain below target in the world's major economies (the consumer price index continues to be low in the euro area). The world market price of crude oil fell to around USD 100 by mid-August. This may have reflected an increase in oil production in Saudi Arabia, the recommencement of production in Libya and the easing of concerns related to the decline in production in Iraq (Chart 3). Favourable trends continued in the world market prices of industrial commodities and unprocessed food. Movements in the world market prices of manufactured goods remained moderate (Chart 4).

Chart 4 Industrial producer prices and tradables inflation in the euro area and world market prices of manufacturing goods



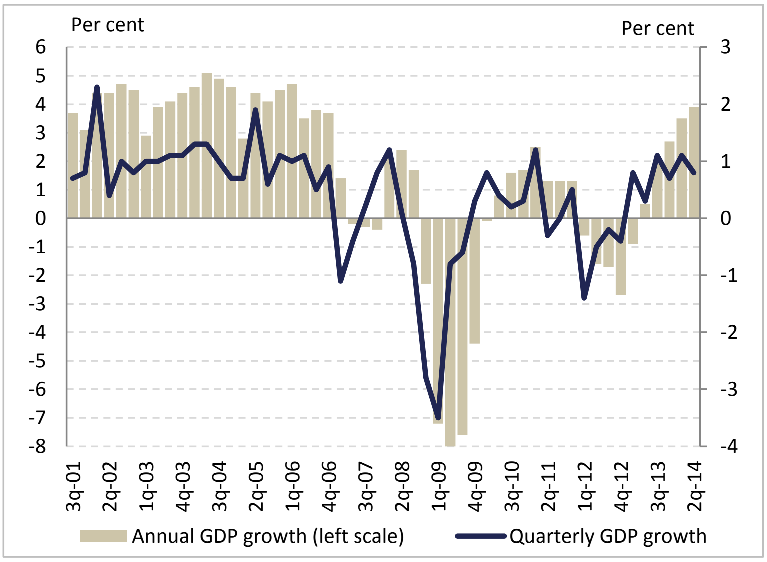
1.2 Domestic real economic developments

Economic growth continued in Hungary in the second quarter of 2014. Available monthly indicators suggest that output grew across a wide range of economic sectors, and domestic demand may have continued to pick up. Furthermore, whole-economy employment continued to rise, reflecting both increasing private sector demand for labour and public employment programmes.

1.2.1 Economic growth

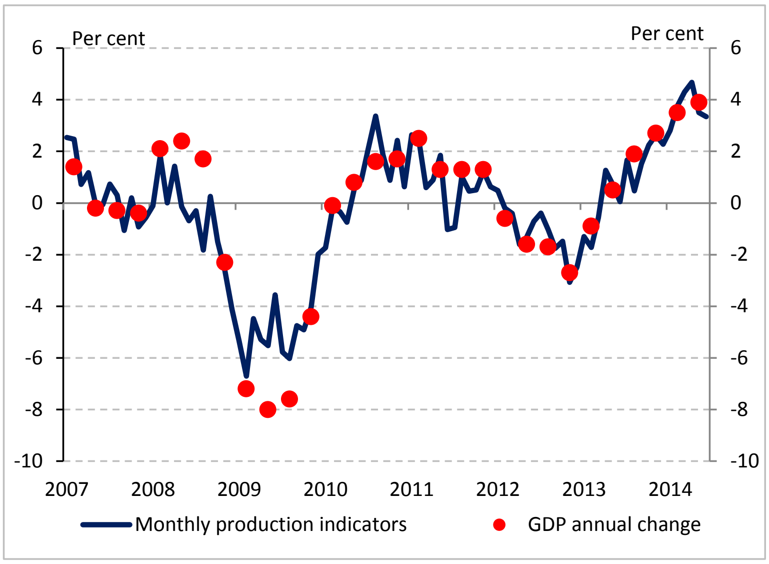
In the second quarter of 2014, the economy continued to grow. Hungary's gross domestic product rose by 3.9 per cent relative to the same period a year earlier and by 0.8 per cent relative to the previous quarter (Chart 5)**.**

Chart 5 Hungary's GDP



Based on the production indicators for recent months, robust growth may well have continued during the third quarter (Charts 6 and 7). The performance of industry, construction and retail sales continued to expand year on year. In June, industrial production rose relative to the previous month and continued to grow strongly relative to the same period a year earlier. The favourable underlying developments in industry continue to be driven by the expansion in vehicle industry capacity. In addition to this, the rate of output growth increased across a range of sectors. In June, construction output slowed significantly relative to the previous month.

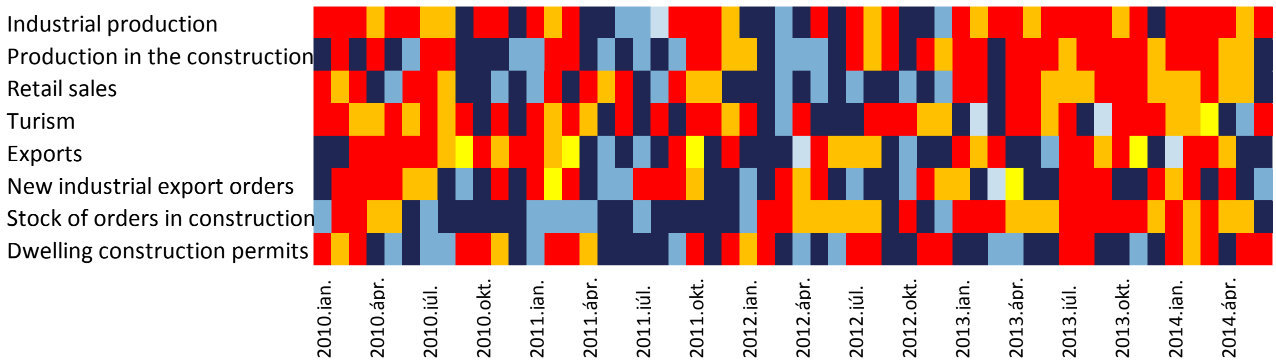
Chart 6 Monthly production indicators and GDP growth*



* Weighted average of monthly production indicators (industrial output, construction output and retail sales). The weights are derived from regression explaining GDP growth.

Economic growth may have been balanced, and both exports and domestic demand may have picked up in the second quarter. Investment activity may have been the main driving force behind GDP growth, but consumption and exports may also have continued to expand.

*Chart 7 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.

Industrial production posted a year-on-year increase of 11.3 per cent and 1.6 per cent in June relative to the previous month. Production increased across a wide range of manufacturing sectors. The output of the motor vehicle sector, accounting for a significant weight, and the related industries grew the most strongly. The output of the electronic and optical industry, which fell sharply during the crisis but nevertheless retained a significant weight, grew for the fourth consecutive month in June. Industrial export and domestic sales by industry both rose sharply in June. **Goods exports continued to rise, in line with developments in industry.**

Construction output continued to rise in June (by 9.8 per cent year on year). Government investment activity mainly in infrastructure, financed from EU funding, contributed strongly to the performance of construction. Private sector investment remained subdued. Based on the favourable data from construction, **building-type investmentsignificantly in the first half, and data on the stock of orders point to good performance of construction in the second half.**

The gradual increase in consumption demand may have continued in recent months. According to preliminary data, retail sales rose by 1.5 per cent in the first quarter year on year.[1] The pick-up in sales volumes across a wide range of products since the start of the year slowed in June relative to previous months. The improvement in the labour market and the significant rise in household real income, reflecting the historically low inflation environment, are underpinning the upturn in household consumption. However, the recovery is likely to be gradual, reflecting the still-strong presence of precautionary savings and balance sheet adjustment by households.

The June baseline projection pointed to continued economic growth with a balanced structure. The economy is expected to expand by 2.9 per cent in 2014. Growth is likely to continue on a quarterly basis, with the slowdown in the annual dynamics appearing as the result of base effects. The monthly indicators were in line with the Bank's expectations in June. The recovery in domestic demand, the intensive use of EU funds, loose monetary conditions, the improvement in the labour market and the strengthening in business and consumer confidence all supported growth.

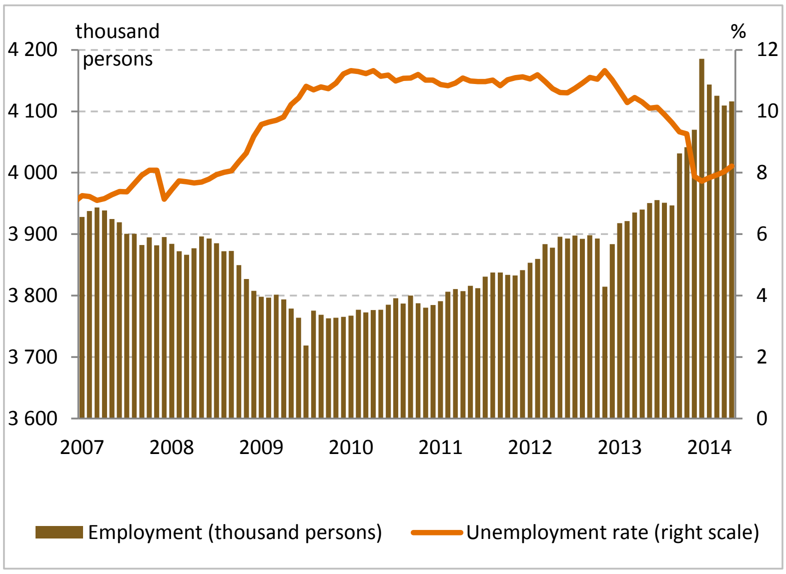
1.2.2 Employment

According to Labour Force Survey data, **the number of employees in the national economy rose by 4.1 per cent in June relative to a year earlier.** This rise mainly reflected the increase in public employment; excluding public employment, the number of employees has been flat in recent months. According to preliminary data, private sector employment rose slightly in the second

[1] In January 2014, the Central Statistical Office changed the method of monitoring the turnover of tobacco products. Instead of the representative sample-based assessment, it switched to the full data supplied by Nemzeti Dohánykereskedelmi Nonprofit Zrt. The figure published by CSO contains the tobacco turnover under the old methodology until June 2013 and under the new methodology thereafter, which results in a structural break in the time series. For this reason, in our analysis we present the index by carrying on the old methodology.

quarter. **Unemployment has been rising slowly since the beginning of the year, with the unemployment rate at 8.4 per cent in June** (Chart 8). The slight fall in the number of employed persons since the start of the year mainly reflects the decline in the number of people employed in public employment programmes, which has led to a slight increase in the unemployment rate in recent months.

Chart 8 Numbers employed and the unemployment rate



The number of newly announced, non-subsidised jobs fell in the second quarter relative to the previous period, according to data released by the National Employment Service. **The labour market is less loose** than at the end of last year, but the indicator of labour market tightness showed a reversal from its elevated level in the first quarter (Chart 9).

Chart 9 Indicators of labour market tightness

Sources: CSO (Labour Force Survey) and National Employment Service.

1.3 Inflation and wages

Inflation has been at historically low levels in the recent past. Favourable cost and demand developments, subdued imported inflation and the adjustment of expectations all contributed to the low inflation environment. At the beginning of 2014, the private sector wage index accelerated, before stabilising in recent months.

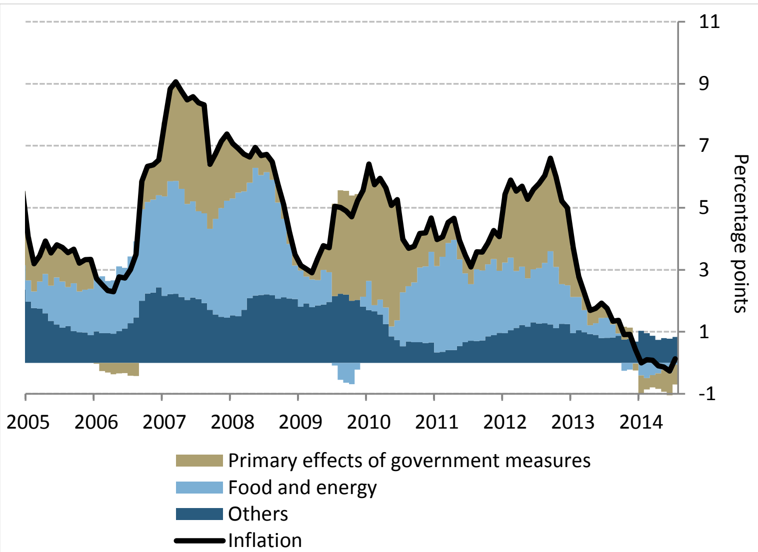
1.3.1 Wages

In the first quarter the private sector wage increase accelerated. The payment of bonuses due in December last year was deferred to the beginning of 2014 and the modest pick-up in regular pay growth may have contributed to this acceleration. The growth rate of wages stabilised in April. **Overall, wage dynamics remained subdued, and unit labour cost in the private sector increased moderately in the first quarter.** In June, the private sector wage index was 4.8 per cent, slightly exceeding the Bank's expectations. Wage dynamics in the services sector was higher than in previous months; and the manufacturing wage index was broadly unchanged at levels seen in previous months.

1.3.2 Inflation developments

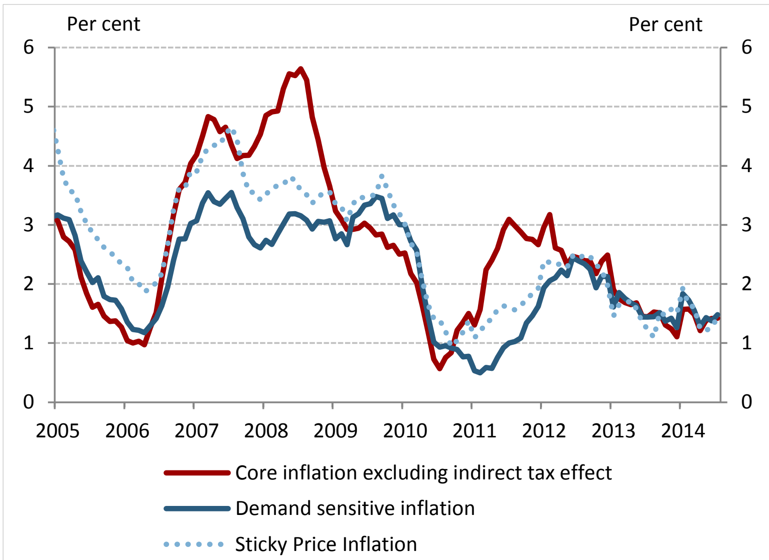
In July, consumer price inflation stood at 0.1 per cent and core inflation at 2.5 per cent, and core inflation excluding the effect of indirect taxes was 1.4 per cent (Chart 10). Inflation rose by 0.4 percentage points and core inflation was unchanged relative to the previous month. The rise in inflation mainly reflected the increase in the price index for unprocessed food.

Chart 10 Decomposition of the consumer price index



Favourable cost and demand developments, the gradual adjustment of expectations and low imported inflation may have contributed to moderate the underlying inflation recorded in recent months (Chart 11). In June 2014, agricultural producer prices fell by 9.8 per cent in annual terms, while domestic sales prices of the sectors producing consumer goods rose by 1.0 per cent. Based on retail sales data, consumption demand may have increased gradually in the past months, in line with year-on-year rises in real incomes. Despite this, however, the volume of retail sales remained significantly below levels seen in the years prior to the crisis. Consequently, domestic demand is likely to continue to exert a disinflationary impact, though this effect is gradually declining.

Chart 11 Measures of underlying inflation



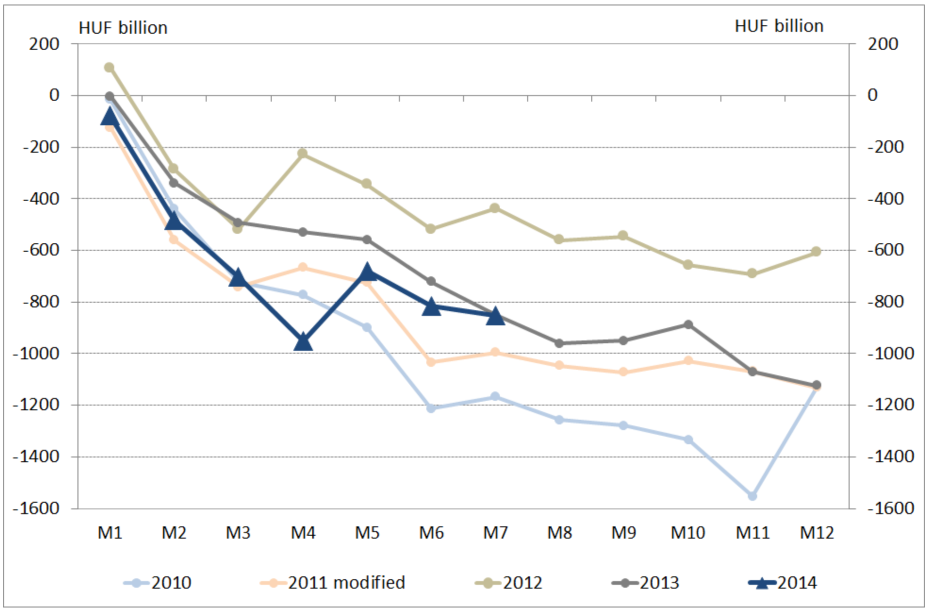
Inflation in Hungary is expected to remain around 0 per cent in the short term. The June–July inflation data were broadly in line with the projection in the June *Inflation Report*. Inflation is expected to sink into the negative domain in the coming months. The inflation rate is likely to rise from the end of the year as the effects of the regulated energy price reductions of last autumn would wane.

1.4 Fiscal developments

In July, the government budget registered a deficit of HUF 38 billion, which was HUF 92 billion lower than a year earlier. On the revenue side, the difference is explained by the effects of favourable macroeconomic developments on consumption and wages. On the expenditure side, there were contrasting developments: net expenditures by the budgetary units and chapters and medical-preventive care exceeded levels seen last July, but this effect was more than offset by lower net interest expenses and other expenditure.

The government deficit amounted to HUF 851 billion in the first seven months of the year, accounting for 86 per cent of the annual target. The cumulative deficit was broadly the same as a year earlier (Chart 12).

Chart 12 Intra-year cumulated balance of the government budget



1.5 External balance

In the future, the background material will also contain a brief analysis of domestic balance of payments data each month, in line with publication of monthly balance of payments data for Hungary.

According to preliminary balance of payments data for June, the surplus on trade in goods stabilised at a high level. Hungary's external financing capacity amounted to nearly EUR 550 million, accounted for in broadly equal parts by the current and capital account surpluses. The higher external financing capacity was associated with an increase in the goods surplus and a decline in the transfer surplus, while the deficit on the income account remained broadly unchanged. The use of EU transfers was slightly lower than in previous months, but transfers received continued to contribute significantly to the external surplus of the Hungarian economy.

According to financial accounts data, the outflow of funds was moderate in June, accounted for in large part by the decline in debt liabilities, while non-debt liabilities remained broadly unchanged. Unlike in previous months, the decline in net direct investment, due in part to one-off and seasonal factors, did not continue. At the same time, Hungary's net external debt fell by some EUR 100 million, which was the result of contrasting developments. The external debt of the corporate sector fell, which was only partly offset by the increase in the net external debt of general government, consolidated with the MNB, reflecting an increase in holdings of government securities by non-residents.

According to preliminary monthly data, the external surplus of the Hungarian economy continued to rise in the second quarter of 2014. Based on monthly data, the country's four-quarter external financing capacity rose to 7.8 per cent of GDP in the period, representing an increase of 0.6 percentage points relative to the previous quarter. The increase in the four-quarter value mainly reflected the rising surplus on goods and services exports, while the deficit on the income account fell slightly.

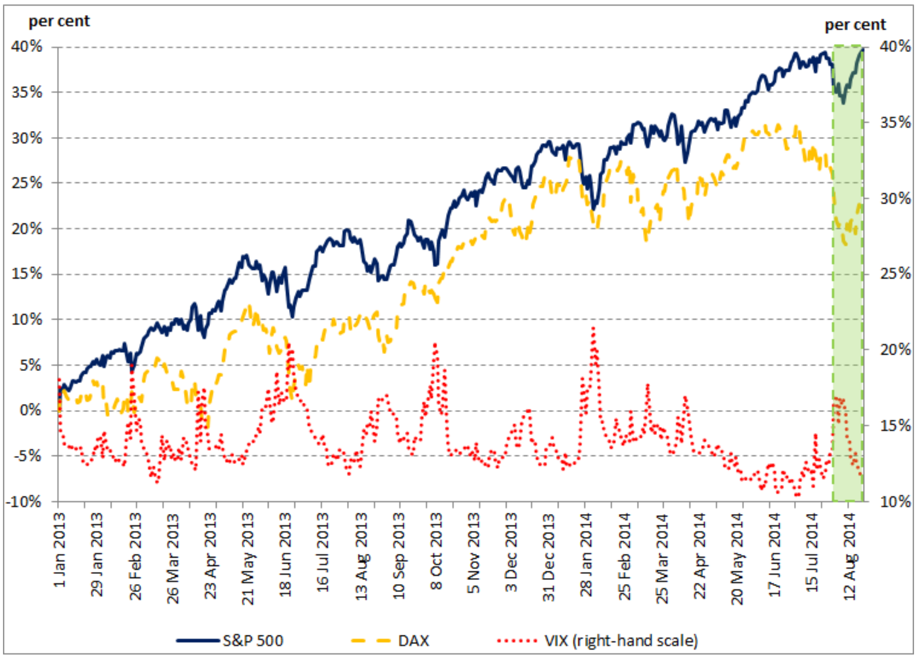
2 Financial market developments

2.1 International money markets

Risk appetite deteriorated significantly in international financial markets over the period following the previous interest rate decision, and then started to improve towards the end. Whereas the existing geopolitical tensions did not lead to a significant deterioration in investor sentiments, risk aversion rose, driven by the intensification of expectations of an interest rate increase by the Fed and the escalation of geopolitical tensions. The VIX index, measuring volatility in equity markets, rose by 3–3.5 percentage points and the EMBI index jumped by 35 basis points. Later the VIX fell back to around levels seen at the beginning of the period, but the EMBI Global reversed its increase only slightly. The levels of the indices are not historically high, but nevertheless represent a change relative to the low volatility environment of previous months. The deterioration in risk appetite was reflected in the weaker performance of equity indices as well as in the pressure on emerging market currencies. However, developed equity markets largely recouped their losses by the end of the period, and a number of US equity indices returned to around historical highs.

Reflecting the divergent interest rate policies pursued by the US Federal Reserve and the European Central Bank, the decline in the US ten-year benchmark yield in recent months first slowed then came to a halt, and the German long-term yield fell below 1 per cent. Whereas the favourable GDP data in the US contributed to strengthening of the dollar, the decline in euro-area inflation to another low, the deterioration in the business outlook and the slowdown in the German, French and Italian economies led to a weaker euro. Consequently, the USD/EUR exchange rate fluctuated near the 1.33–1.34 level at the end of the period. Publication of the minutes of the FOMC’s July interest rate-setting meeting led to a further appreciation of the dollar.

Chart 13 Developed market equity indices and the VIX index (right axis)



The data showing that inflation in the euro area in July had fallen to another historical low were released before the ECB's interest rate-setting meeting, but the Bank did not announce liquidity-providing measures in addition to those introduced in June. President Draghi continued to say that inflation expectations were well anchored, but admitted that growth was modest and uneven and that geopolitical risks had increased significantly, particularly due to the Ukrainian crisis. Expectations of an interest rate increase by the Fed were fuelled mainly by data showing robust GDP growth in the second quarter; however, the labour market data, which turned out to be slightly weaker than in the previous months, elicited little reaction in the markets. Based on the FOMC press release, the Committee saw some improvement in real economic developments and judged that the possibility of inflation remaining below 2 per cent had diminished somewhat. The Bank of Japan and the Bank of England did not change their monetary policies. Analysts expect the first interest rate increase by the Bank of England in the first quarter of 2015. In its latest Inflation Report, the Bank of England stated that wages had not yet increased, despite falling unemployment, and therefore it perceived no inflationary pressure, suggesting a slightly more a mixed picture. However, the minutes of the Monetary Policy Committee's latest meeting reveals that, in contrast with the earlier consensus view that interest rates should be maintained, two members voted to raise rates immediately in July, which might fuel expectations of an interest rate increase.

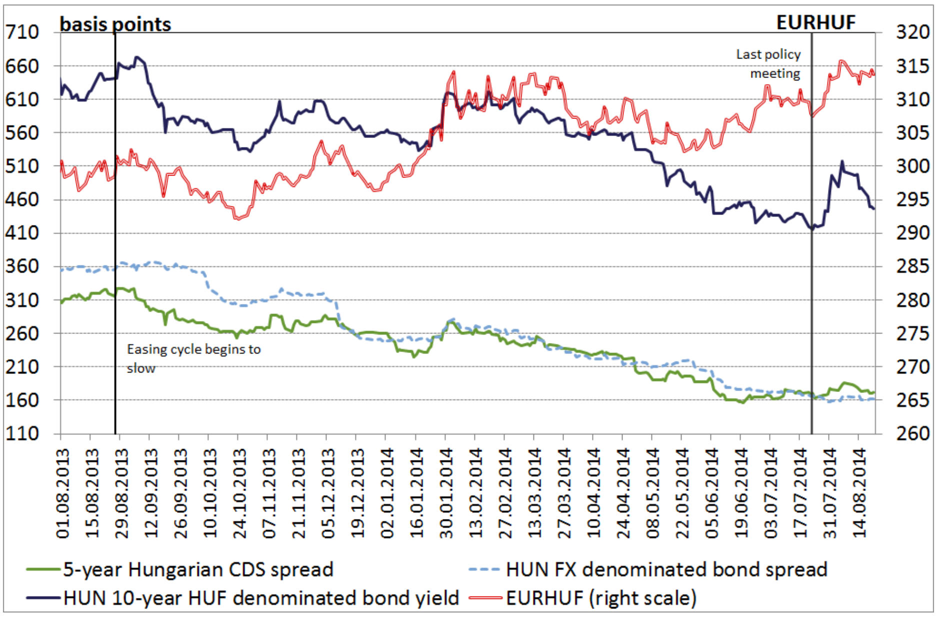
The escalation of geopolitical tensions, and particularly the conflict between Ukraine and Russia and the effects of the sanctions imposed by the EU and the US on Russia, and then later the counter-sanctions announced by Russia, contributed to negative sentiment in global financial markets. Furthermore, the conflict in the Middle East and the technical default of Argentina also contributed to a deterioration in market sentiments, but tensions have eased somewhat in recent weeks. An array of unfavourable macroeconomic data from the euro area suggests that the recovery of the euro area remains fragile, which is further amplified by the effects of the sanctions on Russia. CDS spreads and ten-year yields in the periphery countries jumped in response to the announcement of the Russian ban on agricultural imports and unfavourable Italian and German macroeconomic data, then returned to earlier levels by the end of the period, and therefore remained broadly unchanged.

In the CEE region, consumer price index data continue to indicate the presence of disinflationary pressures. In terms of GDP growth, the performance of Romania and the Czech Republic in the second quarter caused a negative surprise, while growth in Hungary exceeded expectations.

2.2 Developments in domestic financial market indices

Domestic financial market developments were influenced mainly by international trends and, to a smaller extent, by country-specific events. The forint exchange rate strengthened after the easing cycle was ended, which contributed positively to the currency performing similarly to those of other countries in the region. Following this, however, the forint depreciated, due in part to country-specific reasons, but basically as a result of the deterioration in international sentiments. The EUR/HUF exchange rate fluctuated narrowly after publication of slightly higher-than-expected inflation data and stronger-than-expected GDP growth.

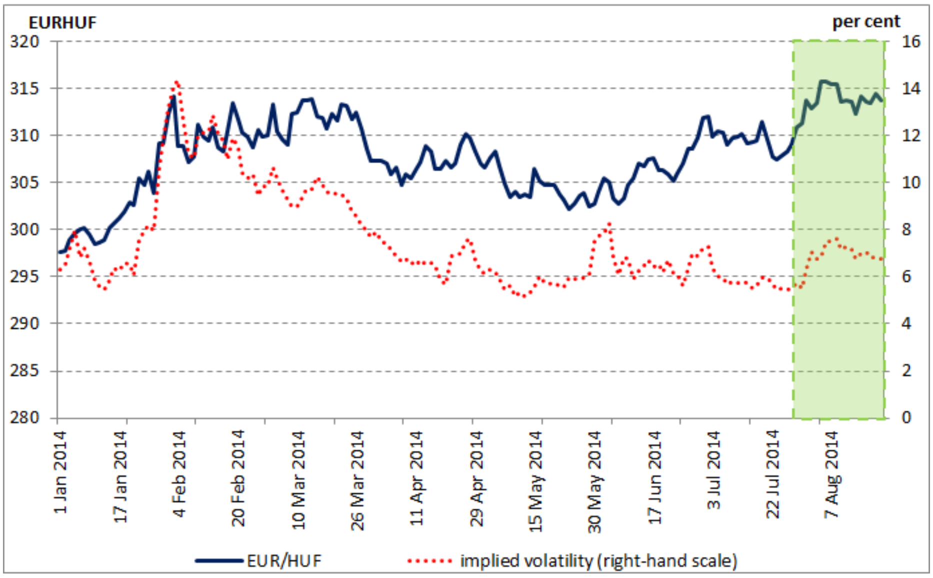
Chart 14 Domestic risk indicators



The overall similar performance of the forint to that of other regional currencies was associated with greater volatility, with analysts explaining its increased sensitivity to shocks with several country-specific factors. On balance, the EUR/HUF exchange rate fluctuated between 307 and 317. **With its 1–1.5 per cent depreciation against the euro, the performance of the forint was about average compared with other currencies of the region, but its volatility was higher than in the case of the reference group.** Initially, the measures of volatility and skewness increased only slightly as an effect of the exchange rate depreciation, but then they continued to rise in response to the escalation of the conflict between Ukraine and Russia, and responded with a slight delay as the exchange rate strengthened. On balance, the level of the measures is lower than at the time of the market turbulence at the end of January, but slightly higher than in previous months. The depreciation of the exchange rate was not significant, although it occurred in parallel with a significant increase in turnover in the spot and swap markets.

In the swap market, short-term implied forint yields are below 2 per cent, despite smooth trading conditions, which favours the build-up of profitable positions in case of a forint depreciation. Swap market spreads of less than one week rose, while other within-year spreads fell. Spreads on long-term foreign currency interest rate swaps (CIRS) have fallen by 25–30 basis points in recent months.

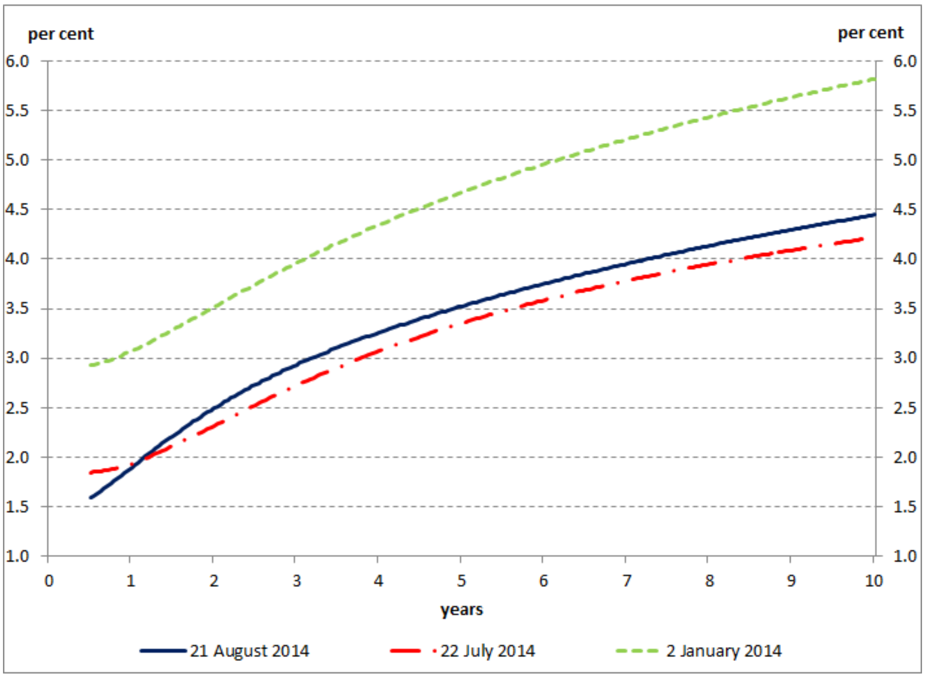
Chart 15 EUR/HUF exchange rate and its implied volatility



The domestic five-year CDS spread has been volatile since the latest interest rate decision, mainly in response to international developments. Its current level of around 165 basis points is broadly the same as at the time of the previous interest rate decision, reflecting a historically low level, but the five-year spread rose as high as 190 in response to international turbulence.

Movements in domestic short and long-term government securities yields were volatile by international standards and the steepness of the yield curve has increased since the last interest rate decision. The short end shifted down by 25–30 basis points and was flat at one year. At maturities beyond one year, yields increased by 25–30 basis points, including a reversal in response to positive sentiment in markets in recent days. On balance, the three-month benchmark yield fell to 1.4–1.5 per cent and the ten-year yield rose to around 4.5 per cent.

Chart 16 Shift in the spot government bond yield curve

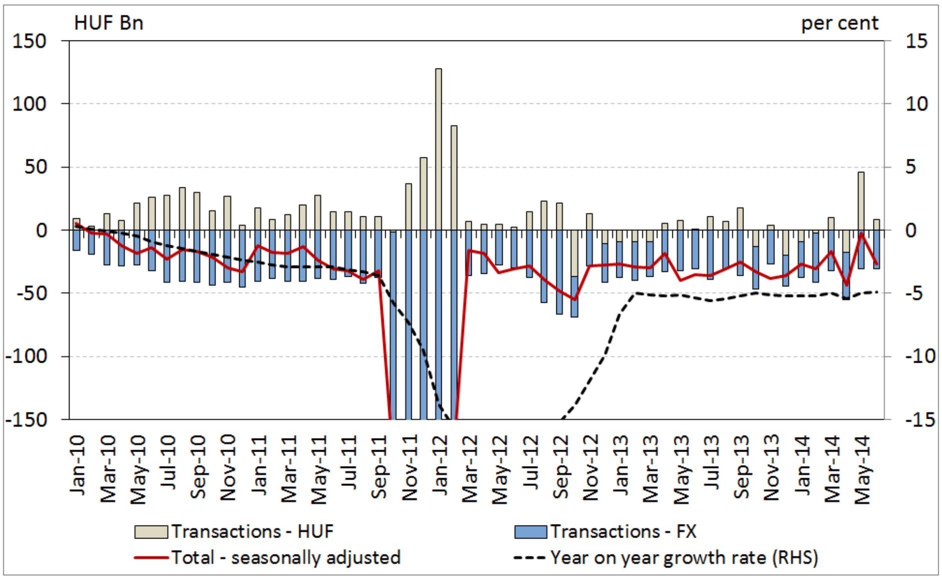


On balance, investor’s demand at the government bond auctions conducted in the period was strong; demand for Hungarian securities, however, dropped below levels seen during the year. **The reduced amount of securities offered by the Government Debt Management Agency and relatively stable demand may have contributed to the decline in short-term yields.** Coverage for long-term securities was adequate, but the Agency reduced the amount of securities on offer at the longer end, which clouds the picture somewhat. In addition, yields rose materially. **Holdings of government papers by non-residents responded to the turbulence in external markets, but were relatively stable between HUF 4,800–5,000 billion,** representing a 42–43 per cent share of the Hungarian government securities market.

3 Trends in lending

In June, households were net repayers of debt, with the sector's transactions amounting to HUF -22 billion (HUF -26 billion seasonally adjusted). As a result, the annual rate of increase changed from -5 per cent in the previous month to -4.9 per cent. The reduction in foreign currency loans continued to account for the fall in the stock of lending, while new disbursements of forint loans exceeded repayments by some HUF 9 billion in the month (Chart 17).

Chart 17 Net borrowing by households



Lending by credit institutions to the household sector amounted to HUF 48.3 billion, up nearly 40 per cent on the same period a year earlier. Lending for house purchases picked up particularly strongly: the volume of new business in this segment was some 50 per cent higher than in June 2013.

In June, outstanding bank lending to the corporate sector increased by HUF 11 billion due to transactions, with forint and foreign currency lending both increasing relative to the previous months (Chart 18). The seasonally adjusted amount of transactions exceeded HUF 34 billion, with the annual rate of growth turning positive. Loans disbursed under Pillar 1 of the Funding for Growth Scheme contributed some HUF 37 billion to the increase in the stock of forint lending in June.

Chart 18 Net borrowing by non-financial corporations