Macroeconomic and financial market developments

November 2014

Background material
to the abridged minutes of the
Monetary Council meeting
25 November 2014

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The background material 'Macroeconomic and financial market developments' is based on information available until 21 November 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

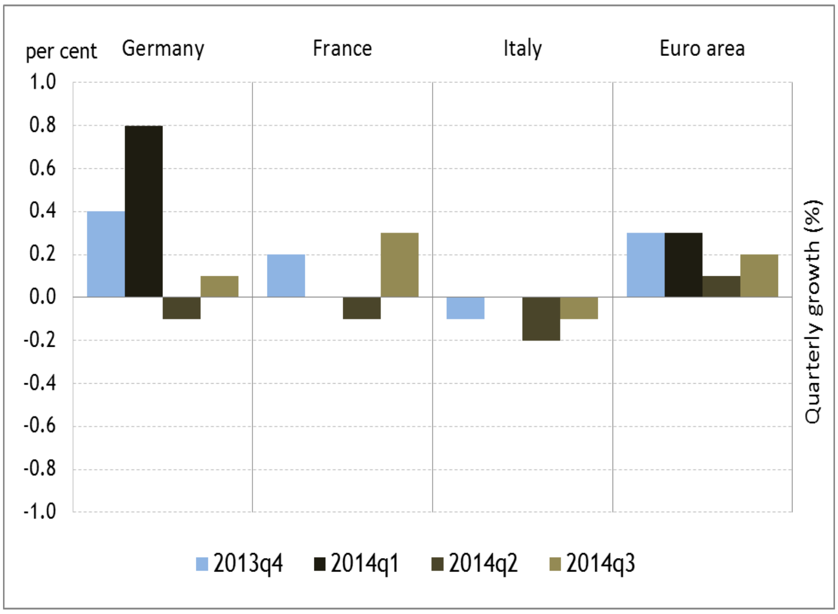
1 MACROECONOMIC DEVELOPMENTS

1.1 The global economy

Based on data for recent months, economic growth in Hungary's export markets has slowed. The outlook for growth this year deteriorated and, looking ahead, the dynamics of growth are likely to be more moderate than previously expected. The outlook for growth in the world's emerging regions also continues to be fragile. Heightened geopolitical tensions may also adversely affect the performance of developed countries through the effects of declining demand and economic sanctions. Inflationary pressures from the world market have remained muted in recent months.

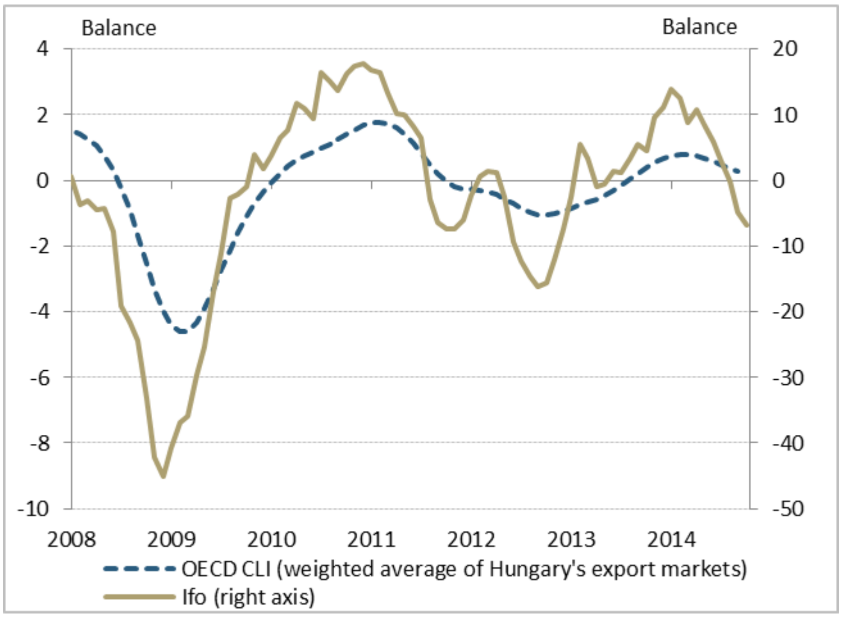
Growth in the world economy continued in the third quarter of 2014, but at a slower-than-expected rate. Based on available preliminary data, growth was consistent with the deterioration in the outlook in previous months. In some euro-area economies, growth turned out to be slightly better. The slowdown in economic activity partly reflected the adverse effects of the conflict between Ukraine and Russia and the related economic sanctions, which may intensify looking ahead. Emerging market economies, where growth had been rapid in previous years, have slowed significantly this year and, looking ahead, growth prospects are modest. This picture is reinforced by the decline in world commodity prices.

Chart 1 Quarterly growth rates in the euro area



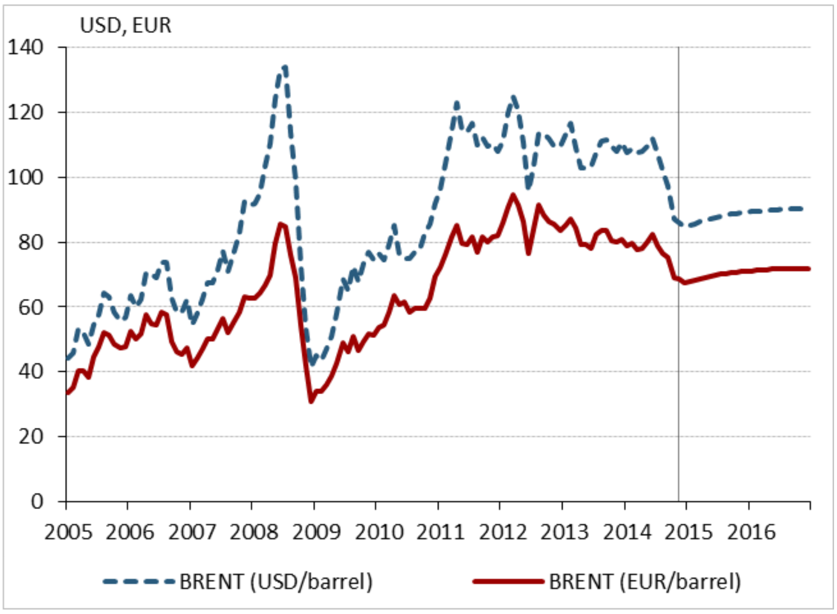
The euro-area economy registered a quarter-on-quarter growth rate of 0.2 per cent in the third quarter of 2014 (Chart 1). Available monthly production data show a slowdown in economic activity, which is consistent with the steadily deteriorating outlook provided by forward-looking indicators in recent months. The slowdown in activity may partly reflect the tense geopolitical situation: the increase in uncertainty and the gradually widening scope of mutual economic sanctions may lead to a slowdown in economic activity. In line with this, third-quarter data showed that growth slowed broadly in line with expectations, as foreshadowed by the deterioration in indicators of economic activity (Chart 2) and production data.

Chart 2 Indicators of activity in Hungary's export markets



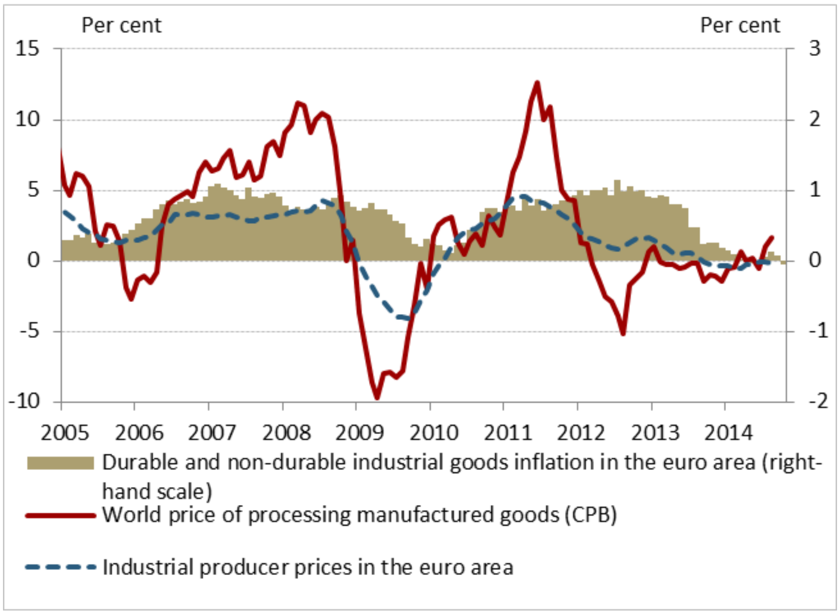
In September, the industrial output of Germany, Hungary's most important trading partner, reversed some of the significant decline from August and the volume of new German industrial orders was unchanged. The performance of Central and Eastern Europe was favourable in the third quarter, but industrial output slowed in the region according to monthly indicators for recent months. So far, the escalation of the conflict between Ukraine and Russia and the slowdown in Europe have had only a limited impact on growth in the CEE region, but looking ahead, the slowdown in the euro area may lead to a weakening in growth in the region as well.

Chart 3 World market price of Brent crude oil



Inflationary pressures from the world market continued to weaken. Declining global commodity prices, combined with slow growth in the global economy, are reducing inflation. As a result, inflation rates remain below target in the world's major economies (the increase in the consumer price index continues to be low in the euro area). The world market price of crude oil continued to fall in early November, with the Brent falling below USD 80. Movements in the price of oil reflect weak demand mainly on account of slack growth in the larger oil-importing economies, in addition to growing supply boosted by an increase in oil production by Saudi Arabia and the pick-up in shale oil extraction in the US (Chart 3). The dynamics of the world market prices of industrial commodities and unprocessed food remained moderate. World market prices of manufactured goods continued to be low (Chart 4).

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



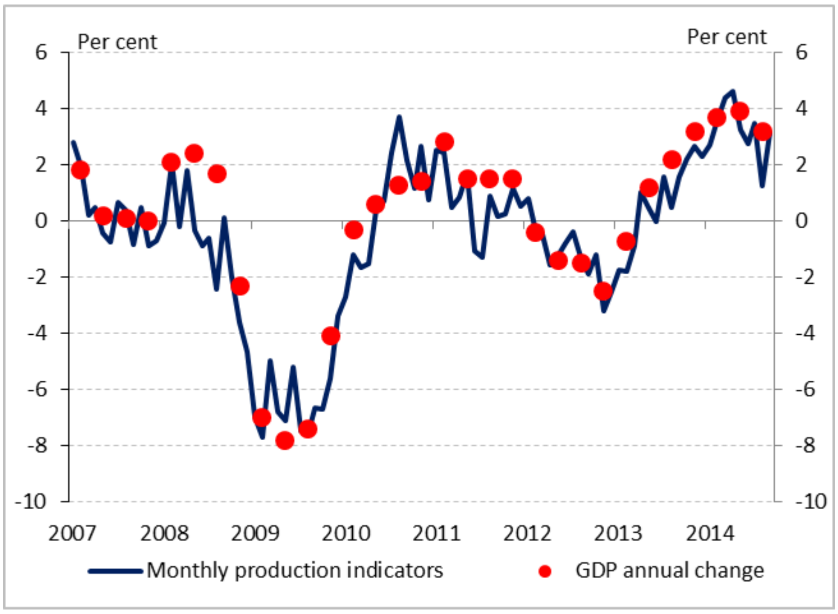
1.2 Domestic real economic developments

1.2.1 Economic growth

The economy continued to grow in the third quarter of 2014. Hungary's gross domestic product expanded by 3.2 per cent relative to the same period a year earlier and by 0.5 per cent relative to the previous quarter.

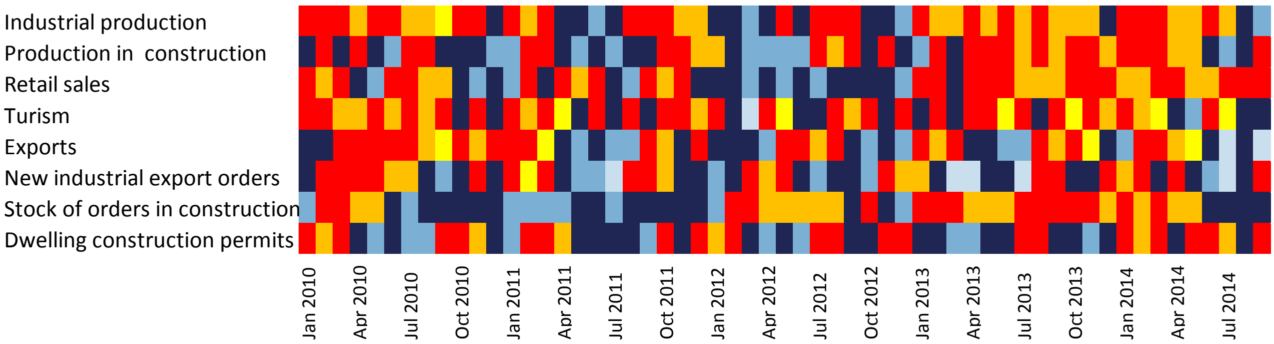
Indicators available for recent months suggested that Hungarian economic growth may have slowed slightly in the third quarter (Chart 5). Production indicators for August showed a somewhat unfavourable picture for domestic economic performance in the third quarter. Industrial production continued to grow slightly relative to a year earlier, but declined sharply, by more than 5.7 per cent on a monthly basis, according to data released by the CSO. Construction output fell by 0.2 per cent in August relative to the previous month. By contrast, industry and retail sales both expanded in September, and construction output also rose.

Chart 5 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.

*Chart 6 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.

In September, industrial production posted a year-on-year increase of 7.6 per cent, reversing some of the decline from the previous month. Output fell by 0.7 per cent relative to the second quarter and rose by 3.3 per cent relative to the previous month. The output of industries producing for the Russian and Ukrainian markets generally declined in September. The output of the food industry, accounting for an important share, fell relative to August, while the chemical, metals and electronic and optical industries saw a slight reversal. By contrast, the output of the vehicle industry, accounting for the largest share, rose relative to the previous month, stagnating overall in the past several months of the year. As a result of the model change in the Suzuki factory, production may slow over the period to the end of the year, and production at the Audi factory is likely to pick up, due to the launch of new production capacity. Forward-looking indicators suggest a deterioration in the short-term outlook, although Hungarian and German new orders show a slight reversal. Exports and imports of goods rose in September, in line with developments in industry, but the trade surplus fell relative to the previous quarter. Import growth was faster quarter on quarter than export growth due to the pick-up in domestic demand. As a result, the contribution of net exports to growth may have diminished in the third quarter.

Construction output rose at a year-on-year rate of 7.3 per cent in September and fell by 1.5 relative to the previous month. Government investment activity focused mainly on infrastructure financed from EU funding continued to be a major factor contributing to the performance of the sector, while private sector investment activity remained subdued. The sharp decline in the number of new contracts for construction observed in recent months and the gradual decline in orders for construction point to a slowdown in this sector's output growth in the fourth quarter.

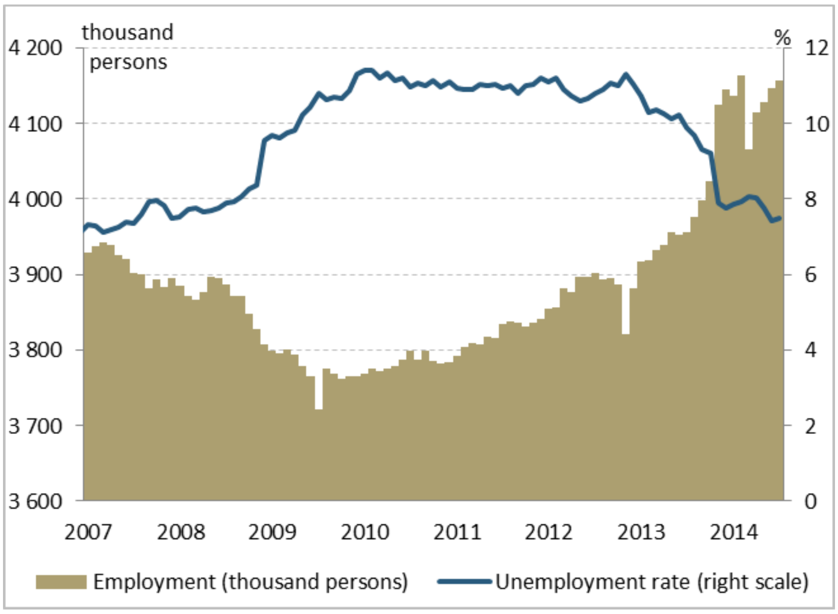
The gradual increase in consumption demand may have continued in recent months. According to preliminary data, retail sales rose by 4.3 per cent in September year on year. The improvement in the labour market and the significant rise in household real income, reflecting historically low inflation, are underpinning the upturn in household consumption. However, the recovery is likely to be gradual, in line with the continued dominance of precautionary savings and balance sheet adjustment by households.

In the baseline projection in the September *Inflation Report*, growth continues with a balanced structure. The economy is expected to grow by 3.3 per cent in 2014. Hungarian economic growth may slow down on a quarterly basis, in part reflecting one-off effects. The recovery in domestic demand, the intensive use of EU funds, loose monetary conditions and the improvement in labour market conditions all support growth, but the weakening in activity internationally and the slowdown in economic growth in Hungary's major export markets represent a downside risk looking ahead.

1.2.2 Employment

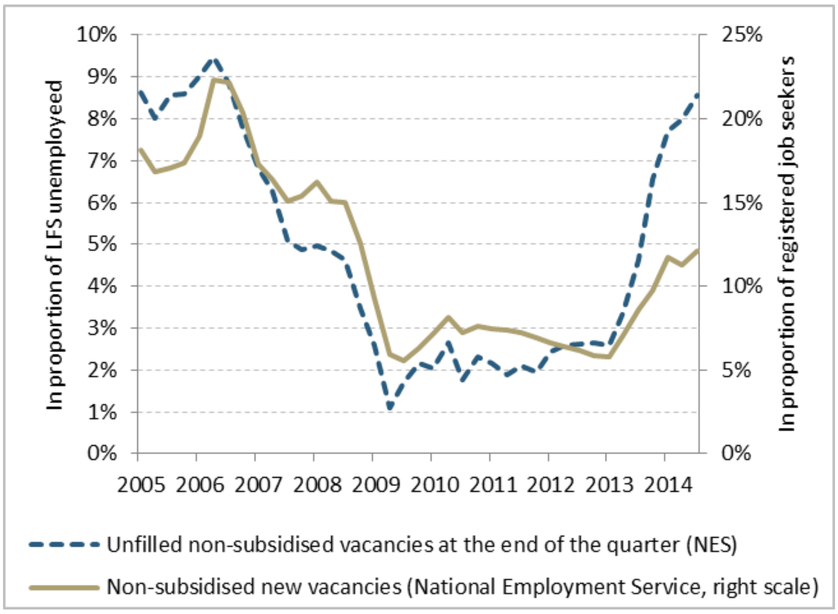
According to Labour Force Survey data, the number of employees in the national economy rose by 4.8 per cent in the third quarter relative to a year earlier. Based on preliminary data, private sector employment was flat relative to the previous quarter. Public sector employment rose. The unemployment rate fell in the third quarter after rising in the previous period (Chart 7).

Chart 7 Numbers of employed and the unemployment rate



The number of newly announced, non-subsidised jobs was broadly unchanged in the third quarter relative to the previous period. The number of vacancies fell slightly, but returned to pre-crisis levels in the past 18 months, which may suggest that mismatches in the labour market are growing. The labour market is tighter than at the beginning of last year (Chart 8). The number of reported lay-offs increased significantly in September, mainly as a result of the closure of the Nokia factory at Komárom.

Chart 8 Indicators of labour market tightness



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

1.3 Inflation and wages

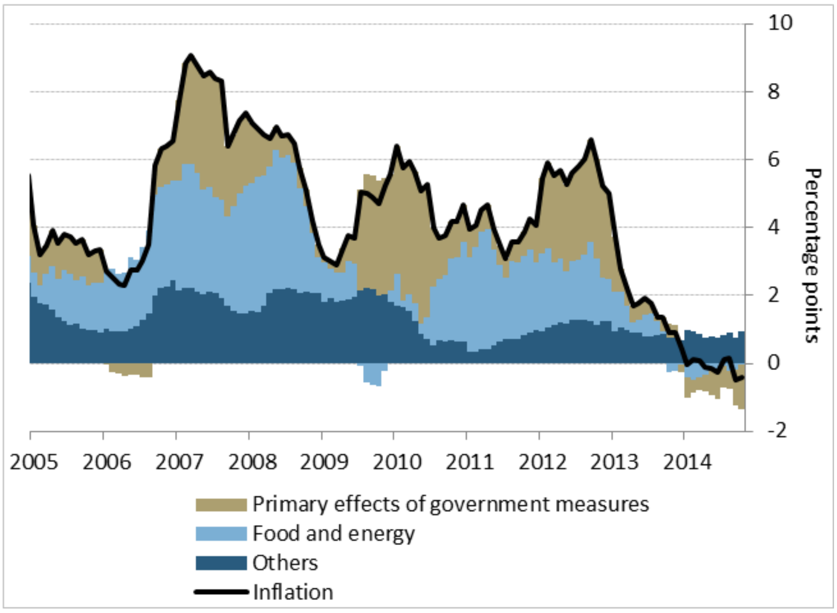
1.3.1 Wages

The private sector wage index rose by 4.6 per cent in September. The rate of gross wage growth rose slightly relative to the previous months. There was little difference between manufacturing and market services in terms of wage growth in the month. Wage dynamics remained moderate, with the rate of growth of unit labour costs in the private sector falling in the second quarter.

1.3.2 Inflation developments

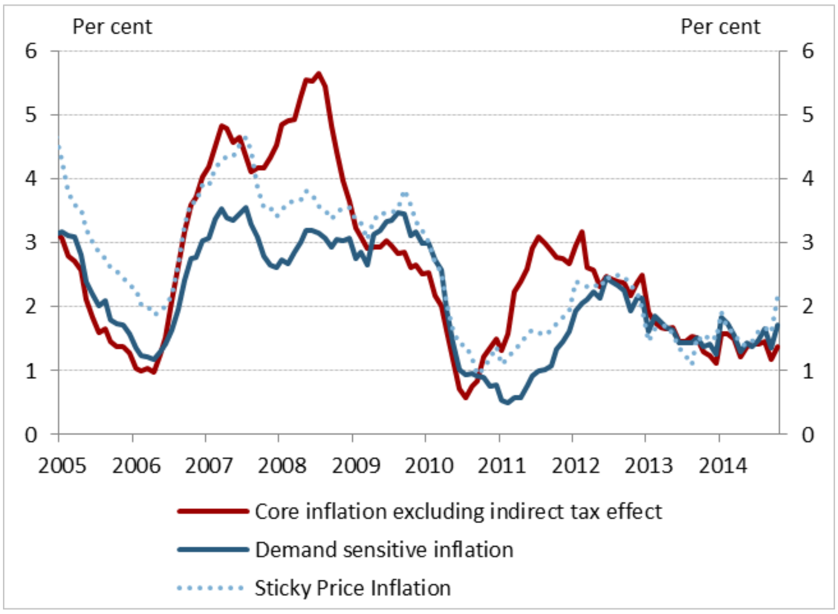
In October 2014, inflation stood at -0.4 per cent, core inflation at 1.5 per cent and core inflation excluding the effect of indirect taxes at 1.4 per cent (Chart 9). Inflation and core inflation both rose by 0.1 percentage point relative to the previous month. The drop in inflation reflected divergent movements in the price indices for a number of product groups in the month.

Chart 9 Decomposition of the consumer price index



Favourable cost and demand developments, the gradual adjustment of expectations and low imported inflation may have contributed to the moderate underlying inflation recorded in recent months (Chart 10). In September 2014, agricultural producer prices fell by 5.1 per cent in annual terms, while domestic sales prices of the sectors producing consumer goods rose by 0.7 per cent relative to a year earlier. Fuel prices fell in October relative to the previous month, reflecting the decline in the world market price of crude oil. Based on retail sales data, consumption demand may have increased gradually in recent 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 fading.

Chart 10 Measures of underlying inflation



Inflation in Hungary is expected to remain around 0 per cent in the short term. The October inflation data were lower than the projection in the September issue of the *Inflation Report*, partly reflecting the effects of lower-than-expected fuel and processed food prices and well as one-off effects (e.g. developments in air fares). The Bank's measures capturing longer-term inflation trends (i.e. inflation rates of demand-sensitive and sticky-price products) rose slightly relative to the previous month, but continued to indicate a low inflation environment. The Bank's view of underlying inflation developments remains essentially unchanged.

Inflation is likely to remain around 0 per cent in the coming months, reflecting the decline in oil prices expressed in forint terms in recent weeks.

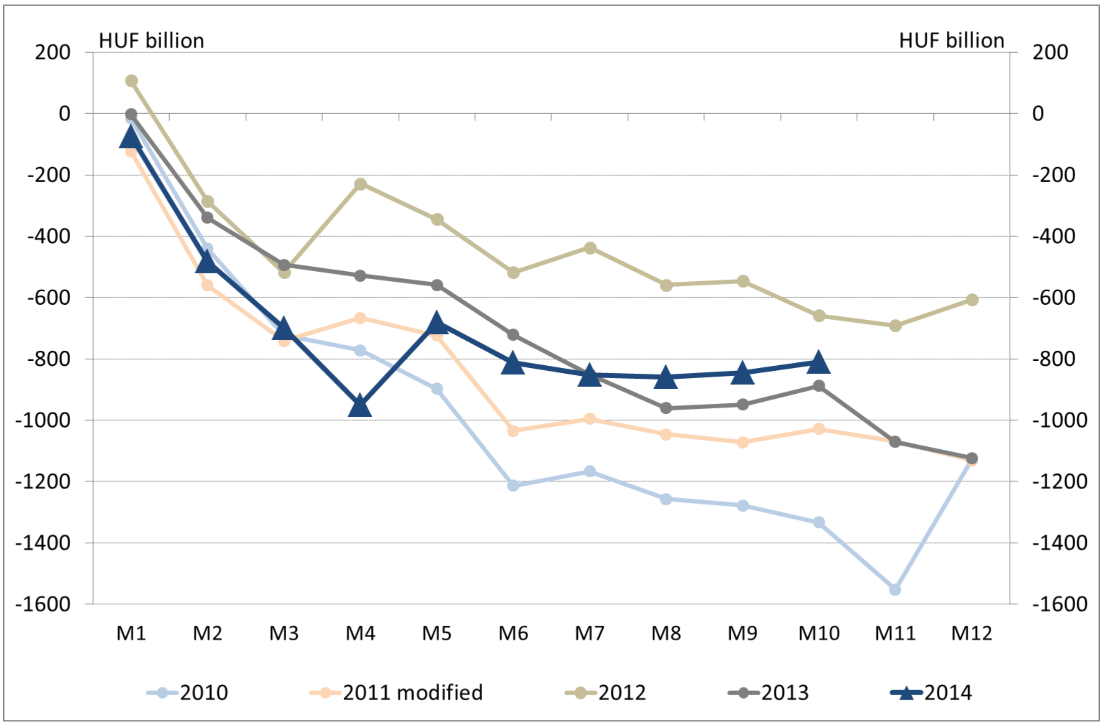
1.4 Fiscal developments

In October, the government budget excluding the local government sub-sector (central government sub-sector) registered a surplus of HUF 35 billion. This was largely the same as one year previously. On the expenditure side of the budget, family allowances and spending related to state property fell relative to a year earlier, reflecting calendar effects, and one-off effects . The decline in revenues mainly reflected the within-year pattern of receipts of EU transfers.

The central government sub-sector registered a HUF 810 billion deficit in the first ten months of the year, equivalent to 82 per cent of the cash-based deficit target envisaged in the Budget Act.

In nominal terms, the cumulative deficit continued to be lower than values recorded in previous years (Chart 11).

Chart 11 Intra-year cumulated balance of the government budget



1.5 External balance

In October, Hungary's seasonally adjusted external financing capacity was in excess of EUR 1.1 billion. The increase in the country's financing capacity mainly reflected the correction in the balance of trade in goods, related to the output of the automobile industry. The transfer surplus continued to be significant, mainly reflecting EU transfers, while the deficit on the income balance remained low.

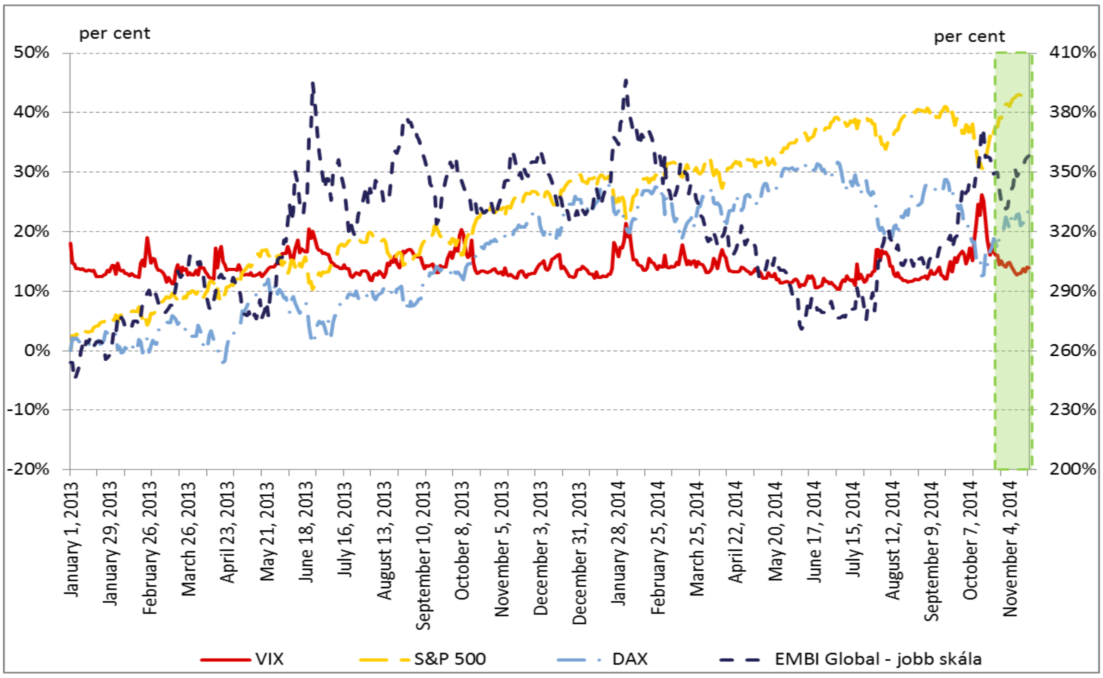
Based on financial account data, debt liabilities continued to fall, while direct investments by non-residents in Hungary increased slightly. In September, the country's financing capacity, calculated on the basis of the financial account, amounted to EUR 240 million. This resulted from an outflow of EUR 400 million in debt liabilities and a slight inflow of FDI liabilities. General government net external debt consolidated with the MNB rose, reflecting an increase in government securities holdings by non-residents and the fall in reserves due to the MNB's swap facility. However, inflows of liabilities at consolidated government level were more than offset by the fall in external debts of banks and companies. Net inflows of FDI reflected the increase in non-resident holdings of shares and a comparable decline in inter-company loans.

2 FINANCIAL MARKET DEVELOPMENTS

2.1 International financial markets

In the period since the Monetary Council's previous interest rate decision, risk appetite has improved in international financial and capital markets, mainly in response to positive news about the US economy and further economic stimulus by the Bank of Japan. The improvement in sentiment was mainly reflected in strong rises in equity indices and declines in risk measures. US equity indices reached historical highs, rising by 4–5 per cent during the period, and developed European indices rose by 3.5–5 per cent. The Japanese Nikkei index rose the most sharply, by nearly 13 per cent, due mainly to stimulus provided to the economy by the Bank of Japan. Since the previous rate-setting meeting, the VIX index has fallen from its high level of around 25 per cent, and currently stands at 14 per cent. The MOVE index, a measure of options-implied interest rate volatility in developed markets, also fell, and the EMBI index, a gauge of emerging market bond performance, was broadly unchanged (Chart 12). There were divergent movements in US and German long-term yields: the US ten-year bond yield rose by 2 basis points and the German yield fell by 8 basis points. In European periphery countries yields generally fell, mainly on account of the sharp increase prior to the last interest rate decision.

Chart 12 Developed market equity indices, the VIX index (left axis) and the EMBI Global (right axis)



In October, the Fed concluded its asset purchase programme, in line with expectations. The wording of the press release issued after the October meeting was maintained: the expression 'for an extended period' remained unchanged in the forward guidance statement for maintaining the federal funds rate at the current low level. Markets, however, were surprised by the optimistic tone of the press release, which highlighted positive data for the labour market and growth, even while the outlook for global growth remained weak. In response to these developments, the market again expects the first interest rate increase to occur in the middle of 2015, although the possibility that such a decision would be postponed in view of heightened uncertainty and statements by central bank officials also arose. Following the publication of the press release, the dollar started to appreciate against the euro and has strengthened by about 1.5 per cent. The dollar appreciation was also supported by positive macroeconomic data in the period, with the faster-than-expected third-quarter GDP growth, at 3.5 per cent, the better-than-expected unemployment data (ADP) and the rise in the consumer confidence index to a seven-year high deserving special mention. The minutes of the FOMC meeting published at the end of the period had a softer tone. As a result, the dollar depreciated slightly.

The Bank of Japan has extended its asset purchase programme. From JPY 50 trillion, it increased its annual asset-buying programme by JPY 30 trillion to a total of JPY 80 trillion and tripled the amount spent on buying exchange-traded investment funds and real estate investment funds. In response to the stimulus package, the yen depreciated significantly, by 10 per cent to reach a record low against the dollar and weakened by nearly 8.5 per cent against the euro. At the end of the period, the yen depreciated again in response to the release of weaker-than-expected preliminary GDP data for the third quarter. By contrast, the Nikkei moved little in response to the release.

Markets judged the press conference held after the ECB's interest rate-setting meeting to have an easing bias. President Mario Draghi suggested that decision-makers were ready to introduce further policy easing measures. This may be required by slow economic growth and low inflation. After the press conference, the euro weakened by 1 per cent against the dollar and equity markets rose. Euro-area HICP inflation was 0.4 in October, representing an increase of 0.1 percentage point on the previous month. The European Commission expects the euro-area economy to grow by 0.8 per cent this year and by 1.1 per cent next year. All of this suggests continued sluggish growth. In addition, the Commission expects euro-area inflation to be 0.5 per cent, 0.8 per cent and 1.5 per cent in 2014, 2015 and 2016, respectively, i.e. it considers that the inflation target of around 2 per cent, set by the ECB, is unlikely to be met over the next two years.

Despite the larger-than-expected 150-basis point official interest rate increase, the Russian rouble continued to depreciate. After temporary appreciation following the interest rate increase, the rouble weakened against both the dollar and euro in the period. In view of the continued selling pressure on the rouble, the Central Bank of Russia announced that it would abandon the currency's fluctuation band and introduce a floating exchange rate regime. However, it was stressed that if financial stability was jeopardised, the Bank would intervene in the domestic foreign exchange market. The exchange rate has stabilised against the dollar since the announcement.

2.2 Developments in domestic financial market indices

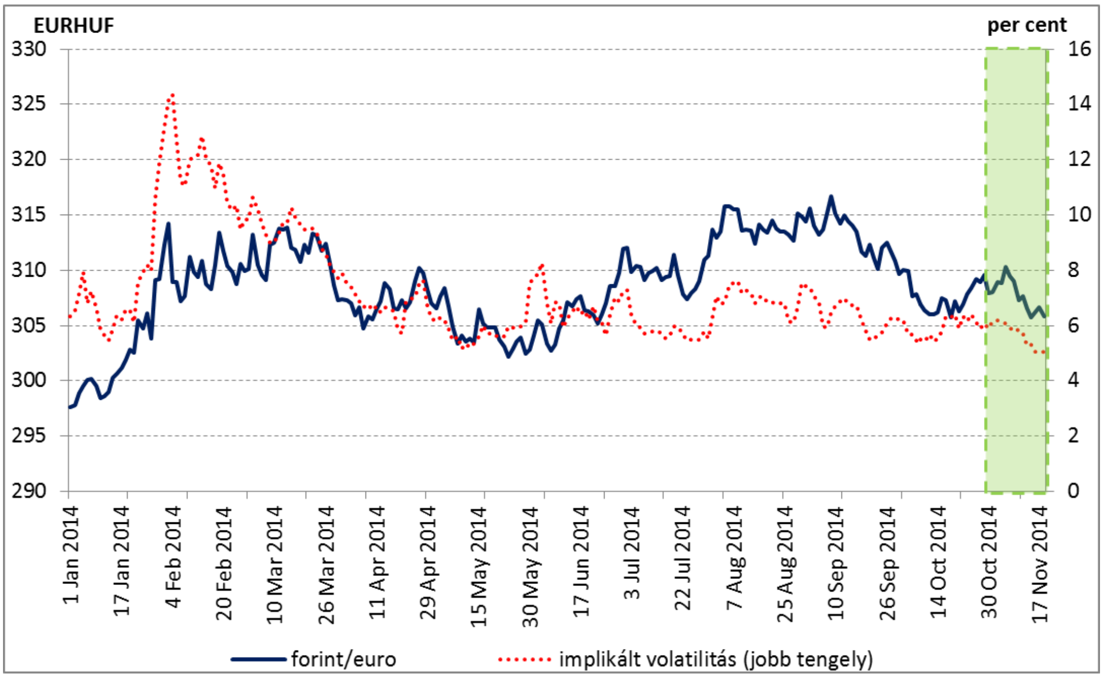
Domestic financial market developments have been influenced by both international and country-specific factors since the Monetary Council's latest interest rate decision. Developments related to the conversion of foreign currency loans into forint had a significant market moving effect.

The latest forecast by the European Commission, published in the autumn, presents an improving picture of the Hungarian economy with GDP growing at 3.2 per cent in 2014, up 0.9 percentage points relative to the spring forecast. In addition, the forecast for 2015 has been revised up by 0.4 percentage points to 2.5 per cent. It is also mentioned in the forecast that this year's 2.9 per cent general government deficit may fall to 2.8 per cent next year, and the risks around the government budget are broadly balanced.Annual inflation forecast for 2014 has been revised down from 1 per cent to 0.1 per cent and the inflation forecast for 2015 has been revised down from 2.8 per cent to 2.5 per cent.

Compared with movements in emerging market exchange rates, currencies of the CEE region were average performers in the period. Their depreciation against the dollar was mainly related to the press release following the FOMC's rate-setting meeting which turned out to be more optimistic than expected, as well as to the dollar's appreciation due to the release of good macroeconomic data in the US. The forint was the only currency in the region which managed to appreciate back to levels seen at the time of the previous interest rate decision by the end of the period. Currencies of the region moved little against the euro. The forint was the only currency which managed to appreciate slightly, while the Polish zloty and the Czech koruna had remained broadly unchanged and the Romanian leu depreciated slightly.

The forint performed slightly better than other currencies of the region. Overall, the EUR/HUF exchange rate fluctuated in a range between 305 and 311 in the period (Chart 13). Appreciating by 1.2 per cent against the euro, the forint was the best performer in the region. News related to the conversion of foreign currency loans into forint contributed to the country-specific appreciation. Markets welcomed news that foreign currency loans would be converted at market exchange rates. The MNB's tenders ensured that banks conducted the necessary conversions outside the market.

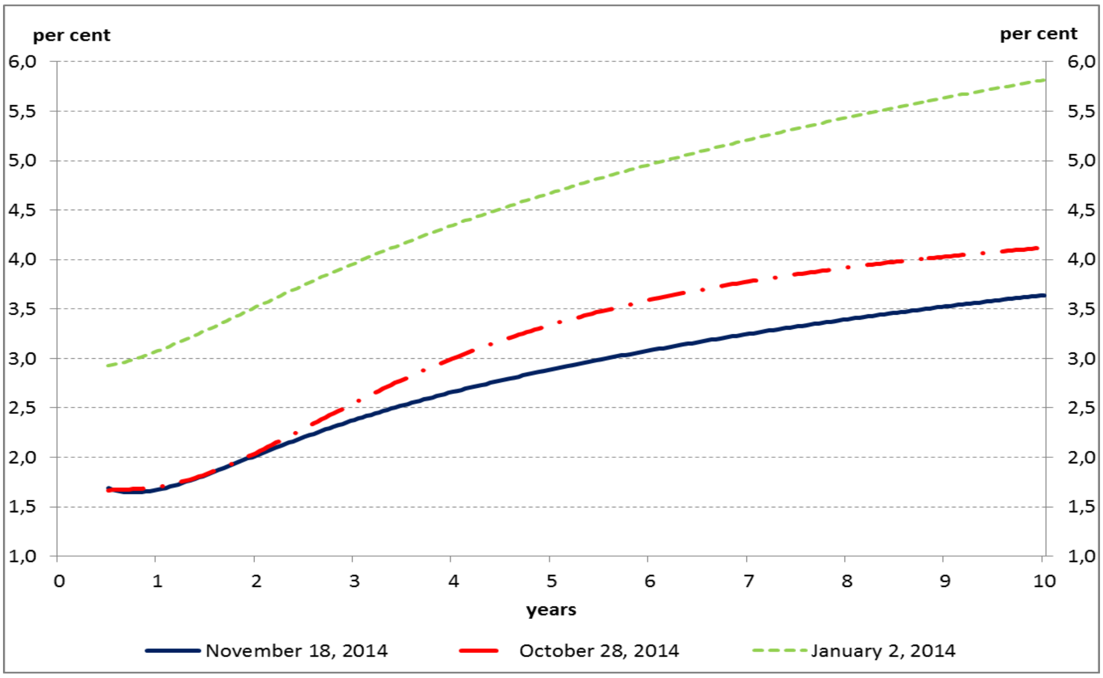
Chart 13 EUR/HUF exchange rate and its implied volatility



The domestic five-year CDS spread has been broadly unchanged since the latest interest rate decision. Its current level of around 170 basis points is low historically. Country-specific factors played an important role in developments in the CDS spread, leading to a significant drop in the second half of the period, while international factors had little impact.

The steepness of the Hungarian government securities yield curve has declined since the latest interest rate decision. The short end of the curve shifted up by 5–10 basis points, approaching the level of the central bank base rate. At maturities beyond one year, yields fell significantly. At maturities of 10 to 15 years, yields fell by 30–40 basis points. The three-month benchmark yield has fluctuated around 1.7 per cent and the yield on the ten-year benchmark paper has fallen to 3.6–3.7 per cent since the previous interest rate decision (Chart 14).

Chart 14 Shifts in the spot government bond yield curve

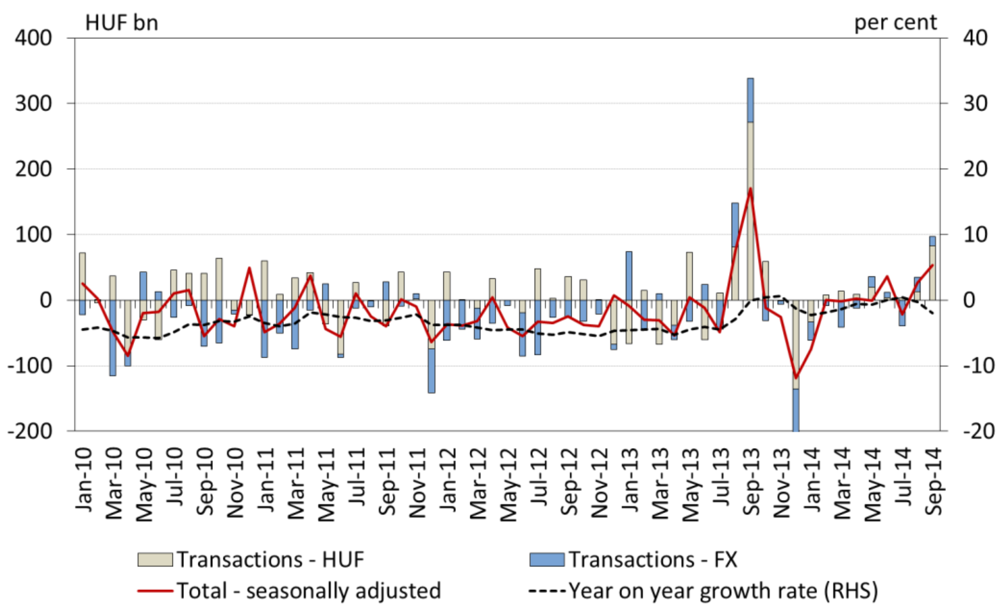


Demand at the auctions for three-month government paper was weak, but investor interest at the auctions held later was greater. Average yields rose at the auctions, and consequently approached the level of the central bank base rate. At the auctions for long-term government securities held since the latest interest rate decision, investor demand was strong. Average yields on these securities fell relative to levels seen in the previous period. Holdings of forint-denominated government paper by non-residents increased by HUF 40 billion in the period and continued to be around HUF 4,700–4,900 billion.

3 TRENDS IN LENDING

In September, outstanding lending by banks to the corporate sector rose by a total of HUF 96.5 billion. Seasonally adjusted, the value of transactions was HUF 53.5 billion (Chart 15). Looking at the currency composition, outstanding forint and foreign currency loans both increased. Loans disbursed under Pillar 1 of the Funding for Growth Scheme contributed some HUF 50 billion to the increase in the stock of forint lending. The transactions-based annual rate of increase fell to -1.9 per cent, due to the dropping-out of the favourable data for last September.

Chart 15 Net borrowing by non-financial corporations



In September, households were net repayers of debt: the value of transactions was HUF -2.6 billion. Seasonally adjusted, the figure was HUF -10.5 billion (Chart 16). In the case of forint loans, disbursements exceeded repayments, as seen in the previous five months, by some HUF 26 billion in September. Continued reduction in the stock of foreign currency loans caused the decline in the total outstanding stock of lending. The annual rate of decline in foreign currency loans fell slightly relative to the previous month, from 4.5 per cent to 4.3 per cent.

Chart 16 Net borrowing by households