Macroeconomic and financial market developments

August 2017

Background material
to the abridged minutes of the
Monetary Council meeting
of 22 August 2017

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The background material 'Macroeconomic and financial market developments' is based on information available until 18 August 2017.

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://www.mnb.hu/en/monetary-policy/the-monetary-council/minutes

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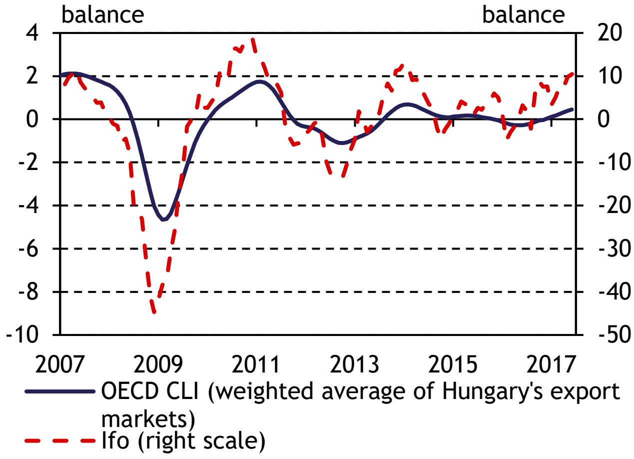
1. MACROECONOMIC DEVELOPMENTS

1.1. Global macroeconomic environment

GDP figures for the second quarter of 2017 showed a positive picture overall. The German economy – Hungary's most important trading partner – further expanded, and economic growth in the USA continued at a faster rate than in the previous quarter. The medium-term view on the European economic activity has improved in recent months.

Chart 1: Business climate indices in Hungary's export markets

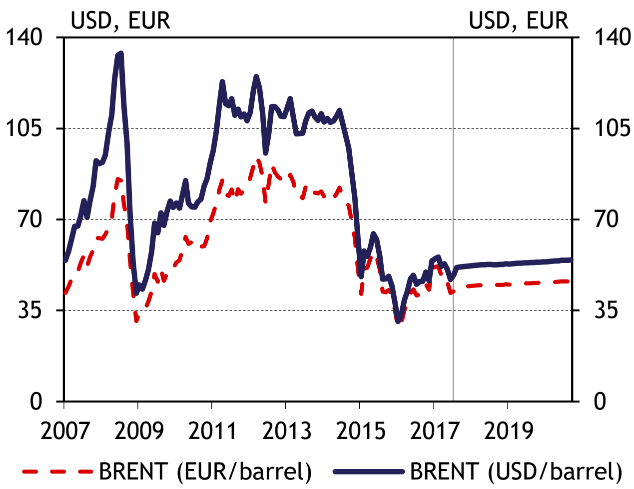


Source: OECD, Ifo

GDP figures for the second quarter of 2017 showed a positive picture overall. Based on seasonally adjusted data, the euro area economy registered a year-on-year growth rate of 2.2 per cent in the second quarter of 2017, while in quarter-on-quarter terms it was up 0.6 per cent. The German economy – Hungary's most important trading partner – further expanded, and economic growth in the USA continued at a faster rate than in the previous quarter. The medium-term view on the European economic activity is still favourable, which is also supported by the high level of the Purchasing Manager Index related to the euro area and the Eurocoin indicator, capturing the underlying economic activity processes of the euro area. Overall, market expectations with respect to the economic growth of the euro area for 2017 have risen. The exit of Great Britain from the EU may still carry significant medium and long-term risks, the process of which is still surrounded by uncertainty as a result of the outcome of the British elections.

The more than three-year stable growth of the German economy, **Hungary's most important export partner, continued in the second quarter of 2017.** The performance of the German economy is still supported primarily by the buoyant domestic demand through the continued expansion in investment and consumption, while net exports made a negative contribution to the German GDP reflecting the substantial growth in import. New industrial orders and the sub-index of the Ifo index reflecting business expectations that capture the outlooks of German industrial production were favourable in recent months (Chart 1).

Chart 2: Brent crude oil world market prices



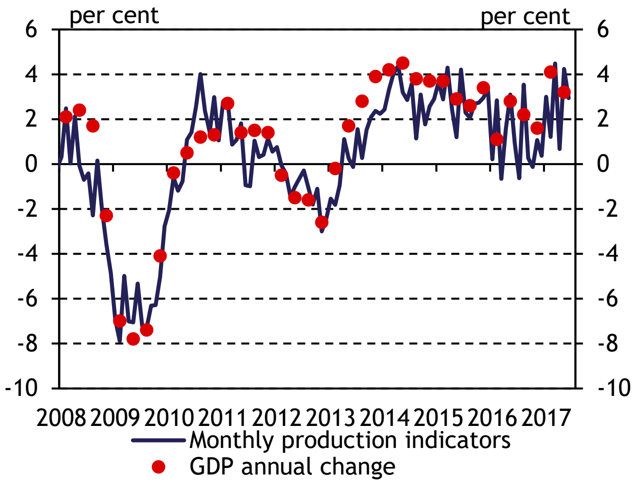
Source: Bloomberg

External inflationary environment remained moderate and continued to carry downside risks. Based on the preliminary data release, the euro area inflation remained unchanged in July. Underlying processes continued to develop moderately. The Brent oil price in July was around USD 48 on average, which was primarily influenced by US production, the news on respecting the production adjustment introduced by the OPEC, as well as the significant world market surplus. The agreements reached at the conference of the OPEC and non-OPEC countries in Saint Petersburg at the end of July pointed toward an increase in oil prices. World market prices of industrial commodities fell, while those of unprocessed food rose in July.

1.2. Domestic real economy developments

According to the HCSO's data release, in 2017 Q2 Hungary's GDP grew by 3.2 per cent year on year. The unemployment rate stood at 4.3 per cent. Private-sector employment continued to increase at a similar rate as in the previous quarter. This increase in the private sector reflected both the expansion of manufacturing and market services, but the contribution construction made was also substantial.

Chart 3: Monthly production indicators and GDP growth



Note: Weighted average of monthly production indicators (industrial output, construction output and retail sales). The weights are derived from regression explaining GDP growth.
Source: MNB calculation based on HCSO data

1.2.1. Economic growth

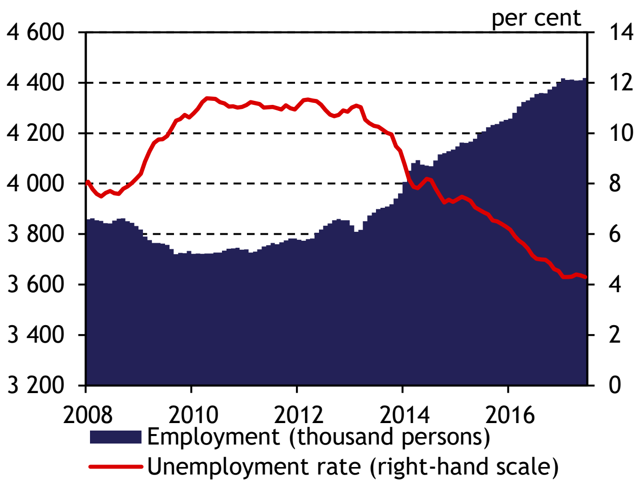
Based on the preliminary data release by the HCSO, in the second quarter of 2017 Hungary's GDP grew at a rate of 3.2 per cent year on year, which was in line with the MNB's expectations. Hungary's GDP grew by 0.9 per cent relative to the previous quarter. Market services contributed to the growth to the largest degree.

Based on the preliminary data release by the HCSO, market services contributed to the growth to the largest degree on the output side in the second quarter of 2017. The details of the production and expenditure side structure of the GDP are not yet available for the public, therefore assumptions can only be formulated about the processes behind received data on the basis of monthly production indicators (Chart 3). Based on monthly data, the dynamic growth of industrial output continued in the second quarter. Construction output significantly increased reflecting the start-up of projects implemented using EU funds, as well as business investments (construction of industrial buildings and warehouses). Retail sales increased following a moderate phase at the beginning of the year.

In June 2017, the volume of industrial output was up by 4.0 per cent year on year, while on a seasonally adjusted basis it fell by 1.2 per cent compared to the previous month. The production level, excluding the working-day effect, rose by 6.5 per cent, and this is explained by having one working day less compared to last June. The output of vehicle manufacturing, representing a considerable share, declined, while other engineering subsectors, as well as chemical and metal industry production increased significantly, year on year. **On the whole, forward-looking indicators reflect a positive picture with regard to the outlooks of the domestic industry.**

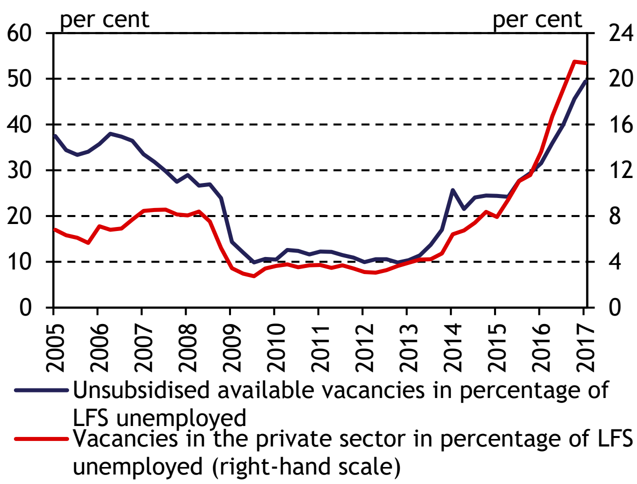
Based on preliminary data, the **value of goods exports and imports increased by 4.5 per cent and 6.5 per cent, respectively, year on year in euro terms** in June 2017, which was in line with the industrial production, thus the trade surplus was down by EUR 97 million compared to last June. In May 2017, the terms of trade continued to deteriorate in which the relative price change of food and processed goods played a role

Chart 4: Number of persons employed and the unemployment rate



Source: HCSO

Chart 5: Indicators of labour market tightness



Source: National Employment Service, HCSO

in addition to mineral fuels. However, relative price change of chemical goods and machinery, transport equipment made a positive contribution to the terms of trade.

In June 2017, **the volume of construction output was up by 27.2 per cent year on year**, while output increased by 1.1 per cent compared to the previous month. Output increased significantly with respect to the construction of buildings and the volume of other constructions. The volume of concluded new contracts increased by 39.6 per cent, while the month-end volume of construction companies' contract portfolio was up 94.5 per cent year on year.

According to the preliminary unadjusted data, **the volume of retail sales was up 5.5 per cent,** in June. Based on calendar adjusted data, it **rose** by 6.0 per cent **year on year**. Turnover increased by 0.6 per cent compared to the previous month. As regards the structure of sales, turnover increased in June in a wide range of products. The material expansion in the turnover of non-food consumer durables primarily contributed to the growth of retail sales, but the rise in food and fuel sales also continued due to last year's high base.

1.2.2. Employment

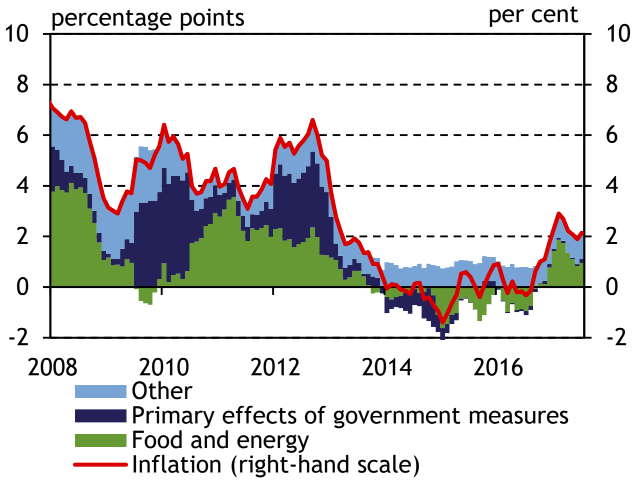
According to Labour Force Survey data, **in the second quarter of 2017 growth in employment continued, simultaneously with a further increase in labour force participation**. Similarly to the previous quarter the unemployment rate **stood at 4.3 per cent** (Chart 4). As a result of the decline in the number of public workers the number of employees in the public sector decreased. **Private-sector employment continued to increase at a similar rate as in the previous quarter.** This increase in the private sector reflected both the expansion of manufacturing and market services, but the contribution construction made was also substantial.

The labour market is still historically tight according to the indicators calculated from the various statistics (Chart 5). In the second quarter of 2017 the number of non-subsidised vacancies indicating corporate labour demand was around 50 thousand, similarly as in recent years according to the data released by the National Employment Service (NES). The month-end number of vacant non-subsidised jobs, showing the matching of structure of labour demand and supply, increased slightly. The number of vacancies in the private sector, published by the HCSO as forward-looking data, slightly decreased in the first quarter.

1.3. Inflation and wages

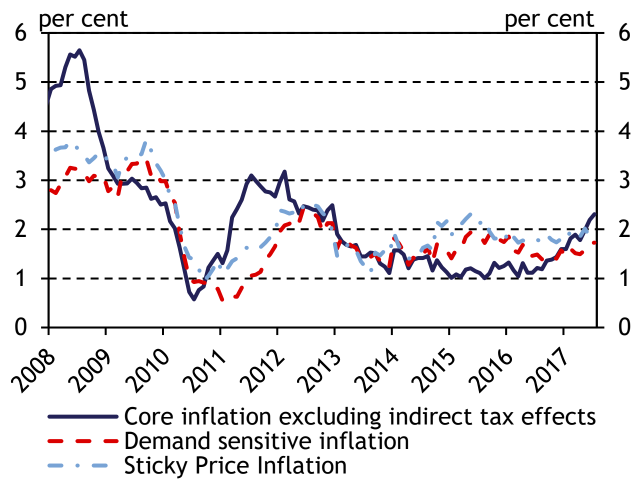
In July 2017, year-on-year inflation was 2.1 per cent, core inflation and core inflation excluding indirect taxes stood at 2.6 and 2.3 per cent, respectively. Underlying inflation indicators are still in the 1.5–2.0 per cent band. In May 2017, private sector gross average wage rose by 10.6 per cent year on year due to historically tight labour market environment and the significant pass-through effect of the high minimum wage and the guaranteed wage minimum raise. Bonus payments in May were substantially lower than those recorded last year.

Chart 6: Decomposition of inflation



Source: MNB calculation based on HCSO data

Chart 7: Measures of underlying inflation



Source: MNB calculation based on HCSO data

1.3.1. Wage setting

In May 2017, private sector gross average wages rose by 10.6 per cent, while regular wages were up 11.9 **per cent year on year**. In the private sector, the growth of both the gross average wages and the regular wages decelerated compared to April. Regular wages developed in line with the usual seasonality of May on a monthly basis. **Bonus payments in May were substantially lower than those recorded last year. Stronger wage dynamics is still explained by historically tight labour market environment and the significant pass-through effect of the high minimum wage and the guaranteed wage minimum raise.**

1.3.2. Inflation developments

In July 2017, year-on-year inflation was 2.1 per cent, while core inflation and core inflation excluding indirect taxes stood at 2.6 and 2.3 per cent, respectively (Chart 6). Relative to the previous month both inflation and core inflation rose by 0.2 percentage points. The rise in inflation primarily reflected the price developments of core inflation items. Core inflation rose primarily as a result of an increase in the price index of processed food, as well as market services, alcohol and tobacco products. The price increase of tobacco products was consistent with raising the excise duty effective from July 2017.

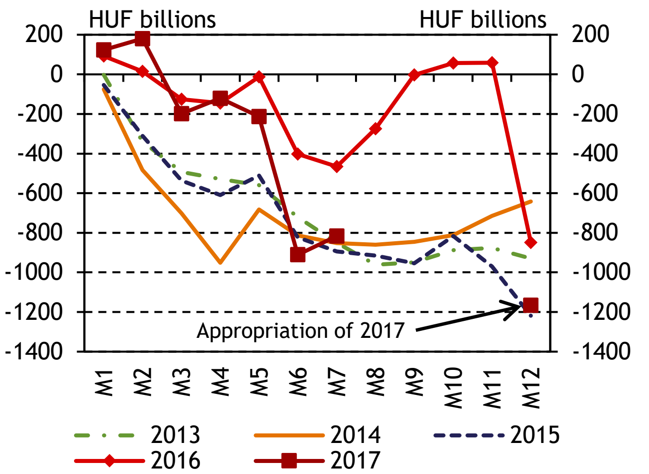
Underlying inflation indicators essentially remained unchanged compared to the previous month, being in the range of 1.5 to 2.0 per cent (Chart 7). In addition to the low level of imported inflation and inflation expectations, moderate commodity prices also contribute to this. In June 2017, agricultural producer prices rose by 2.5 per cent in annual terms, while the domestic sales prices of the consumer goods sectors increased by 5.6 per cent.

Based on the incoming July data both inflation and core inflation basically corresponded to expectations in the June Inflation Report. According to our current forecast in the coming months will be around 2 to 2.5 per cent. Inflation will reach the 3 per cent target sustainably from early 2019.

1.4. Fiscal developments

The central sub-system of the general government closed with a surplus of HUF 94 billion in July 2017, thus the cumulative balance of the current year was HUF -817 billion at the end of the month. The monthly balance in July was higher compared to previous years, while the cumulative cash balance in the first seven months of the year excluding last year, developed in a manner typical of previous years.

Chart 8: Intra-year cumulative cash balance of the central government budget



Source: MNB calculation based on HCSO data

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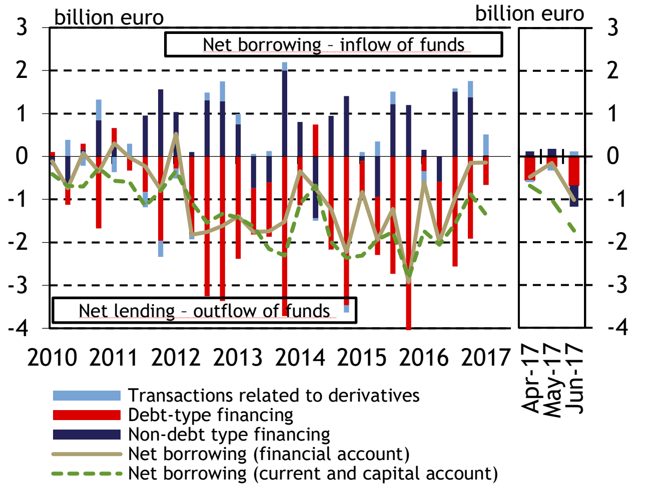
The **revenues of the central sub-system** in July 2017 were up by HUF 177 billion year on year. The significant increase was attributable to the fact that the budget realised a growth in personal income tax and consumption taxes, which was only offset minimally by the income from corporate taxes that declined relative to the previous year.

The expenditures of the central sub-system in July 2017 were up by HUF 20 billion year on year. The increase in the net expenditures of the central budgetary institutions and chapters, relative to the previous year, was offset by the decline in the payment by budgetary institutions related to EU transfers.

1.5. External balance developments

In June, net lending of the economy increased further, and reached a historically exceptional level. Significant payments of EU transfers in June resulted in the substantial increase of net lending, while no material change was observed in the trade balance during the month.

Chart 9: Structure of net lending (unadjusted transactions)



Source: MNB

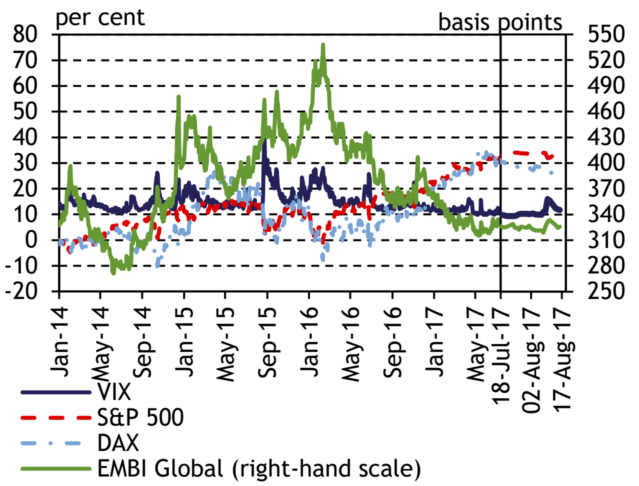
Based on the financing side developments external liabilities continued to fall, which was reflected by the decline in net external debt and foreign direct investments. Net external debt continued to decline, which exceeded EUR 600 million in June. The general government's external debt declined to the largest degree, in which the increase of the claims with the EU related to payments of EU transfers played an important role in addition to non-residents' declining holdings of forint government securities. In addition to the government, corporations also reduced their net external debt, while the banking system increased it which was mainly accompanied by an increase in its long-term external liabilities. A decline in foreign direct investments in June was primarily related to the drop in intercompany loans.

2. FINANCIAL MARKETS

2.1. International financial markets

Investor sentiment in the period since the last interest rate decision was determined by the communications made by the governors of the key central banks and increasing geopolitical tensions. First the communication of the central banks' governors, then the slightly deteriorating global sentiment resulted in a decline in yields of long-term government securities in developed economies. The European and Japanese stock exchange indices declined, while US indices kept up the growth observed at the beginning of the period. The developed currencies' market was determined by the appreciation of the euro, which strengthened by 1.8 per cent against the US dollar. Oil prices rose as a result of the news on the reduction of US inventories and the OPEC meeting in Saint Petersburg.

Chart 10: Developed market equity indices, the VIX index (left-hand scale) and the EMBI Global Index (right-hand scale)

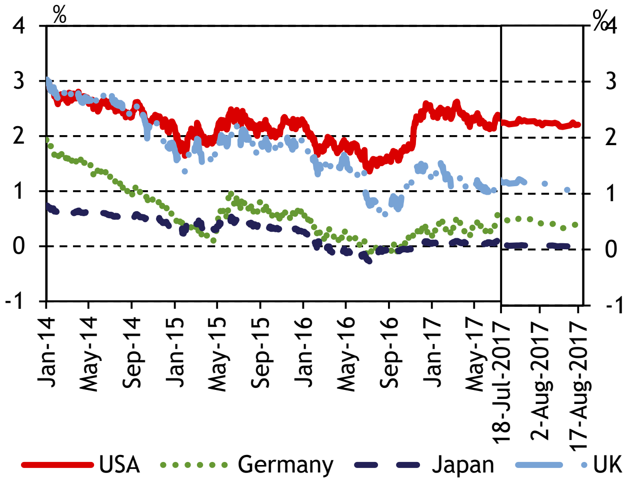


Source: Bloomberg

Risk indicators have increased to a degree since the Council's latest interest rate-setting decision, while the long-term government securities yields of the developed countries declined. Global investor sentiment deteriorated slightly in the period, which reflected the increase of the geopolitical tension between the USA and North Korea. In the slightly deteriorating investor sentiment, US stock exchange indices kept up the growth observed at the beginning of the period; however, European and Japanese indices closed in the negative in the period. Due to the geopolitical tension the risk indices showed a sharp increase, but they adjusted towards the end of the period, thus there was only a moderate upward drift throughout the month. As a result of the communication of the central banks' governors yields of developed long-term government securities declined.

The European and Japanese stock market indices dropped, while the indices rose in the USA. European and Japanese stock exchanges closed the period with a negative result of 1.4 per cent. Of the US stock market indices Dow Jones reached an outstanding increase of 1.7 per cent, the S&P and the Nasdaq showed a more modest increase by 0.2 to 0.3 per cent. Of the risk indices the VIX index measuring the implied volatility of the S&P 500 rose from 10 per cent to 16 per cent during the period; however, it adjusted significantly by the end of the period, closing at nearly 12 per cent. After rising over 19 per cent the implied volatility of the Euro Stoxx returned to the level of 14 per cent observed at the MNB's interest rate decision in July.

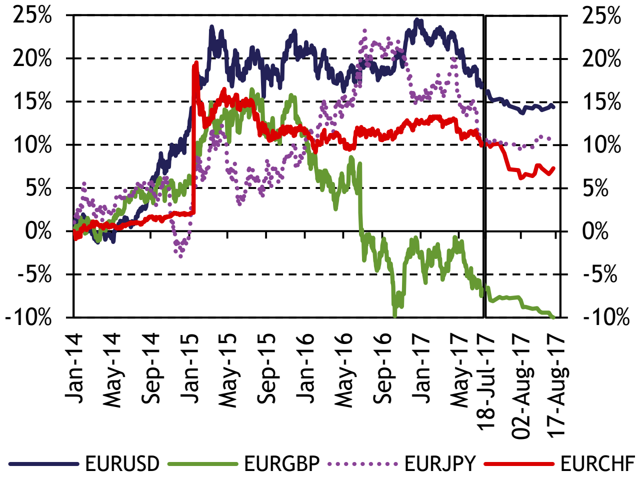
Chart 11: Yields on developed market long-term bonds



Source: Bloomberg

Bond market risk indices rose temporarily, while developed long-term bond yields fell. In the case of the EMBI Global spread representing emerging markets there was a 7-basis-point rise as a result of the increasing geopolitical tension, but on the whole the monthly difference showed only a decrease of 1 basis point by the end of the period (Chart 10). The yields of German and British, the US long-term government securities and the Japanese long-term yields fell by more than 10 basis points,

Chart 12: Developed market FX exchange rates



Note: Positive values indicate the strengthening of the variable (second) currency.
Source: Reuters

4 basis points and 2 basis points, respectively. The yields of long-term government securities in the emerging markets reflected a mixed picture, while yields rose by 10 basis points in the region, in its narrower sense.

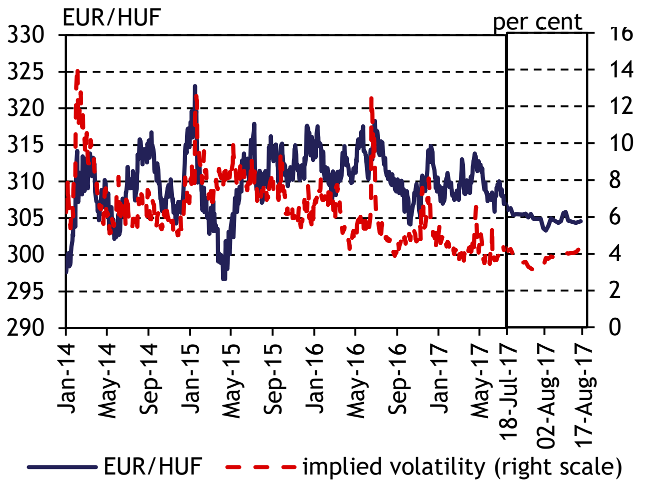
Similarly to earlier developments oil prices were influenced by opposite effects. The rise in oil prices was supported by the decrease of US oil stocks, and the result of the OPEC meeting held in Saint Petersburg. It states that Nigeria also joins the production control agreement, and Saudi Arabia also made an announcement that it would cut its oil exports by a daily 1 million barrels to 6.6 million barrels in August. However, shale oil production in the USA that has been becoming more intensive for over a year, as well as the gradually increasing oil extraction in Libya and Nigeria pointed to a continued decrease in the prices. The Brent and WTI oil prices rose by 4 and 1 per cent, respectively, in the period. The forint appreciated against the dollar by 3.3 per cent during the period, which offset the increase in oil prices, thus no substantial change was observable in the forint value of oil prices.

Neither the ECB nor the Fed have changed their monetary conditions; however, their communication contributed to the depreciation of the dollar against the euro. At its monthly interest rate-setting meeting the ECB did not change interest rates in line with market expectations, and it also left its forward guidance unchanged. In his statement Mario Draghi said that inflation developments are not consistent with the increasing economic performance yet, therefore consultations will only be started after the summer with regards to the phase-out of the asset purchase programme. Draghi's statement regarding the phase-out of quantitative easing was followed by the appreciation of the euro. As expected, the Fed made no changes to monetary conditions, and the press release contained no significant changes compared to the one issued a month earlier. No additional information was provided with regards to the reduction of the Fed balance sheet, which pointed toward the depreciation of the dollar, because on the whole, the market considered the press release mild in tone. Overall, the dollar depreciated against the euro by 1.8 per cent in the past period. The Japanese yen also appreciated against the dollar by 1.7 per cent, while the British pound and the Swiss franc depreciated against the dollar by 1.2 to 1.3 per cent.

2.2. Developments in domestic money market indicators

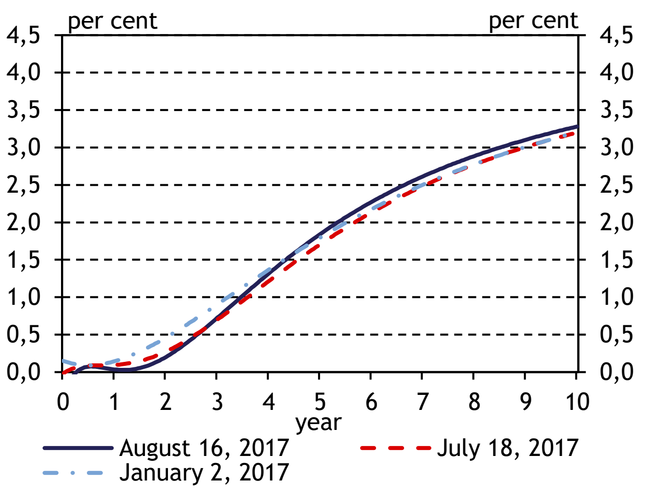
The forint exchange rate strengthened by 0.7 per cent against the euro, which means that it outperformed in the foreign currencies in the region. The government securities market yield curve became steeper, as in addition to the slight fall in short-term yields, in a less favourite international sentiment long-term yields rose simultaneously with the developments in the region. Non-residents' forint government securities holdings rose slightly. Despite the deterioration of global risk appetite, the Hungarian CDS spread decreased by 8 basis points to below 100 basis points.

Chart 13: EUR/HUF exchange rate and the implied volatility of exchange rate expectations



Source: Bloomberg

Chart 14: Shifts in the spot government bond yield curve



Source: MNB, Reuters

The forint appreciated slightly against the euro in the period. This process took place gradually. On the whole, the forint/euro exchange rate closed the period with an appreciation of 0.7 per cent (at 304.5), **thus it outperformed slightly in the foreign currencies in the region,** as the Czech koruna and the Romanian leu depreciated by 0.2 to 0.5 per cent while the Polish zloty significantly by 1.4 per cent (Chart 13) against the euro. All foreign currencies but the zloty in the region appreciated by 1.4 to 2.4 per cent against the dollar.

The government securities market yield curve became steeper: its short-term section moved 3 to 10 basis points down; however, the long end of the curve rose by 3 to 15 basis points (Chart 14). The increase of the second market long-term yield corresponded to the changes in the region: the Romanian and Polish ten-year yield rose by 13–14 basis points, while the Czech yields basically stagnated.

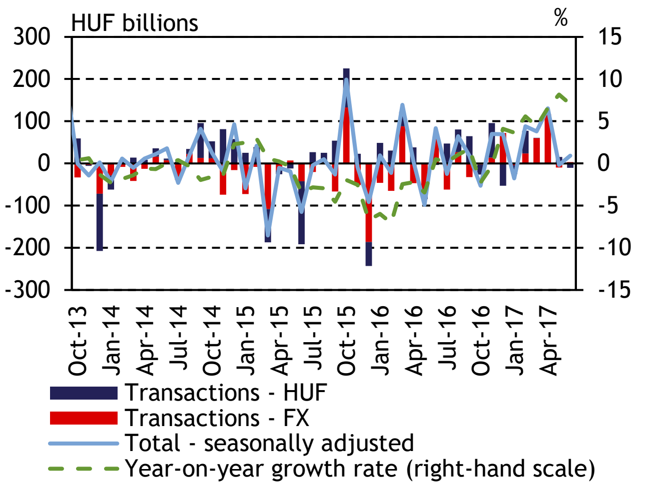
On the whole, demand at the bond auctions of the period was adequate. In the case of the auctions of three-month discount Treasury bills the cover ratio was 1.5–2-fold, while the average yield reached at the auctions decreased by 1 basis points to 0.01 per cent. As regards the 12-month discount Treasury bill there was a sufficient demand and low average yield. At the auctions of long-term government securities, the demand intensified relative to the end of the previous period, and in each case, it was more than twice as much as the offered amount. As a result, the Government Debt Management Agency raised the volume of accepted offers in a number of cases. The yields of 5- and 10-year auctions remained broadly unchanged relative to earlier periods: yields were still around 1.8 and 3.1 per cent.

Non-residents' forint government securities holdings increased by as much as HUF 64 billion to HUF 3,426 billion in the period. Their share in forint government securities is still around 22–23 per cent. Despite the deteriorating global geopolitical sentiment, the Hungarian 5-year CDS spread decreased by 8 basis points to below 100 basis points.

3. TRENDS IN LENDING

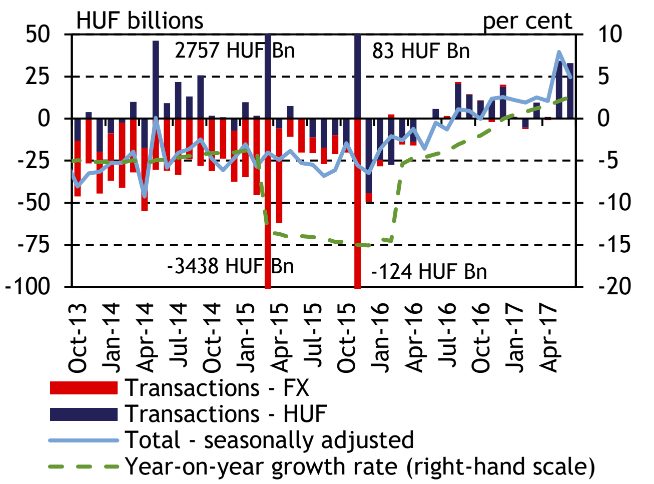
In June, the outstanding corporate loans of credit institutions fell by HUF 7 billion due to transactions. The outstanding loans of the credit institutions to households rose by HUF 32 billion in total as the combined balance of disbursements and repayments, thus at the end of June the annual growth in outstanding lending was 2.6 per cent. The smoothed interest rate spread of forint corporate loans rose slightly by 0.1 percentage point and stood at 2.3 percentage points.

Chart 15: Net borrowing by non-financial corporations



Source: MNB

Chart 16: Net borrowing by households

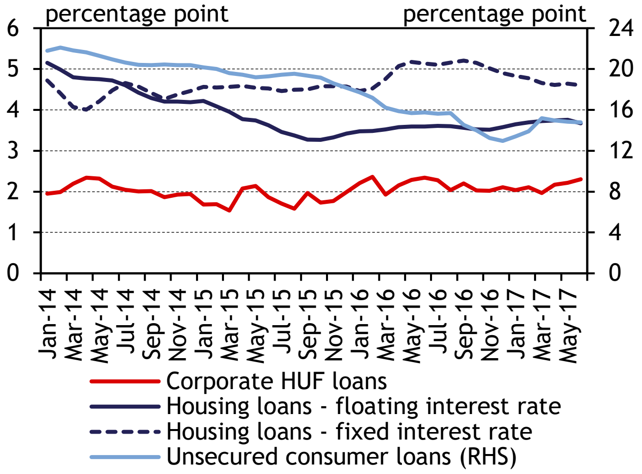


Source: MNB

In June, the outstanding corporate loans of credit institutions fell by HUF 7 billion due to transactions, which is equivalent to an increase of HUF 19 billion on a seasonally adjusted basis (Chart 15). In a breakdown by foreign currency, forint loans decreased by some HUF 10 billion, while foreign currency loans increased by HUF 3 billion. The gross amount of total new loans in June was up 28 per cent in annual terms. Excluding money market transactions, the volume of new loans amounted to HUF 333 billion during the month. The stock of corporate loans increased at a faster rate, by 7 per cent in annual terms in June 2017 due to transactions.

The outstanding loans of the credit institutions to households rose by HUF 32 billion in total as the combined balance of disbursements and repayments, thus at the end of June the annual growth in outstanding lending was 2.6 per cent (Chart 16). The value of new contracts concluded during the month amounted to HUF 138 billion, thus in annual terms it registered a growth of 46 per cent. As regards the individual sub-segments, the volume of new housing loans, personal loans and car purchase loans rose by 35, 51 and 38 per cent, respectively.

Chart 17: Development of corporate and household credit spreads



Note: Three-month smoothed spreads on the APR. In the case of corporate forint loans, the 3-month BUBOR. In the case of variable-rate or for up to one year fixed-rate housing loans 3-month BUBOR, while in the case of over the year fixed rate housing loans the corresponding spread over the IRS

Source: MNB

The smoothed interest rate spread of forint corporate loans rose slightly by 0.1 percentage point and stood at 2.3 percentage points (Chart 17). However, small-amount market loan spreads – typically taken by SMEs – exceeded the average of the other Visegrád countries by 0.9 percentage point. The average interest rate spread (APR) on housing loans to households calculated using the annual percentage rate is still 4.6 percentage points, which can be considered high in international comparison. The spread on unsecured consumer loans to households still stood at 14.8 percentage points in June. Typically, banks justify the increase by becoming more open to riskier clients and the composition effect. The problem of high spreads affects primarily the market of long-term fixed-rate transactions.