Macroeconomic and financial market developments

September 2016

Background material
to the abridged minutes of the
Monetary Council meeting
of 20 September 2016

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The background material 'Macroeconomic and financial market developments' is based on information available until 16 September 2016.

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 usually 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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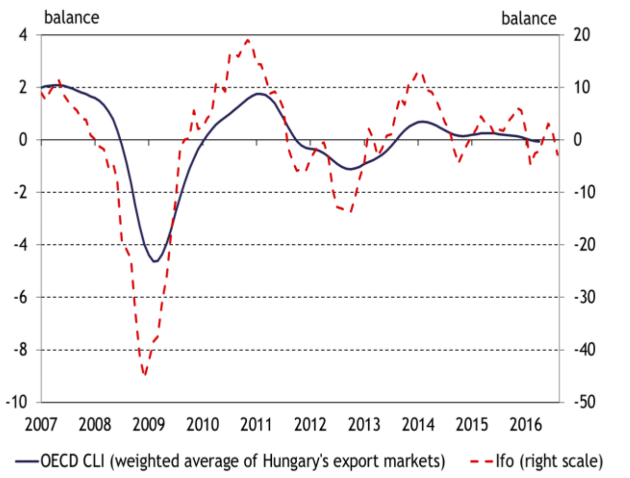
1. MACROECONOMIC DEVELOPMENTS

1.1. Global macroeconomic environment

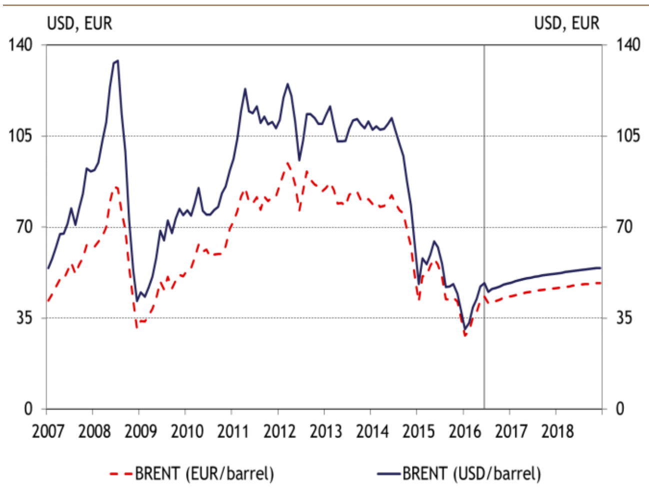
Preliminary GDP figures for the second quarter showed a mixed picture overall. Growth in Germany – Hungary's most important trading partner – was more favourable than expected, while expansion in the USA fell short of economists' projections. Looking ahead, growth remains fragile, surrounded by several downside risks. The fragility of the outlook for economic activity is exacerbated even further by the subdued performance of the German industry. Depending on the outcome of exit negotiations, the effects of the UK referendum may also have a negative impact on the performance of the Hungarian economy. Inflationary pressure from the world market has remained muted in recent months.

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



Source: OECD, Ifo

Chart 2: Brent crude oil world market prices



Source: Bloomberg

GDP figures for the second quarter showed a mixed picture overall. Growth in Germany – Hungary's most important trading partner – was more favourable than expected, while expansion in the USA fell short of economists' projections. Looking ahead, global growth is expected to decelerate in the coming quarters. Low commodity prices continue to drag on commodity exporters' activity growth, while persisting geopolitical tensions slacken growth in developed countries through weaker demand and economic sanctions. Over the short term, the effects of the UK referendum may be concentrated on the United Kingdom for the time being, but depending on the outcome of exit negotiations, they may also have a negative impact on the performance of the Hungarian economy over the medium and long term.

The euro area economy registered a quarter-on-quarter growth rate of 0.4 per cent in the second quarter of 2016. The exit of the United Kingdom from the EU carries significant medium- and long-term risks. Supported by increasing domestic demand and rising exports, economic growth remained dynamic in the second quarter in Hungary's most important export partner, Germany. However, at the beginning of the third quarter the outlook for economic activity began to deteriorate. Both industrial production and German exports declined in July in annual terms, while industrial orders also continued to decrease. Expectations concerning the German economy (Ifo) have been pointing to a worsening outlook since June (Chart 1).

Inflationary pressure from the world market remains weak amid persisting, extremely low commodity prices and subdued demand. As a result, inflation rates remained below target in the world's major economies. In the past month, oil prices fluctuated in the range of USD 43–50 (Chart 2). World market prices of industrial commodities and unprocessed food remained moderate.

1.2. Domestic real economy developments

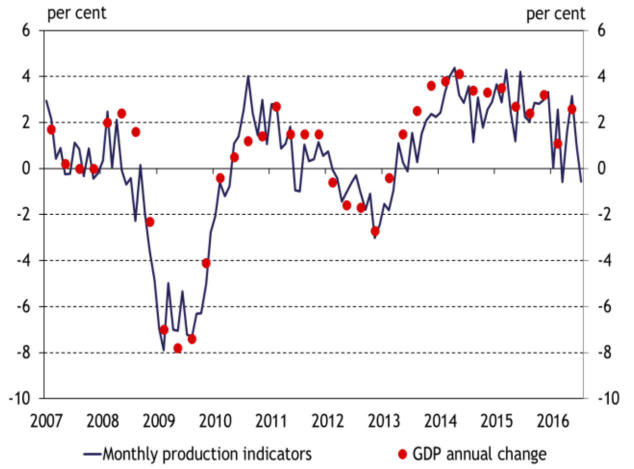
In the second quarter of 2016, Hungary's GDP grew at a rate of 2.6 per cent year-on-year. Following the temporary loss of dynamics observed in the first quarter, the performance of the Hungarian economy adjusted. In July, whole economy employment rose by 2.9 per cent year on year. The unemployment rate stood at 5.2 per cent.

1.2.1. Economic growth

In the second quarter of 2016, Hungary's GDP grew at a rate of 2.6 per cent year on year and by 1.1 per cent compared to the previous quarter. Following the temporary loss of dynamics observed in the first quarter, the performance of the Hungarian economy adjusted in the second quarter. On the output side, economic growth was mainly driven by services linked to internal demand, while final consumption expenditure and net exports boosted growth on the expenditure side.

In the second quarter of 2016, services closely related to the pick-up in domestic demand, the adjustment in industrial output and – thanks to favourable crop yields – the performance of agriculture continued to make a positive contribution to growth. Output expanded in a broad range of the production sectors, while parallel to the decline in the volume of projects financed from EU funds, the construction sector restrained GDP growth considerably.

Chart 3: Monthly production indicators and GDP growth

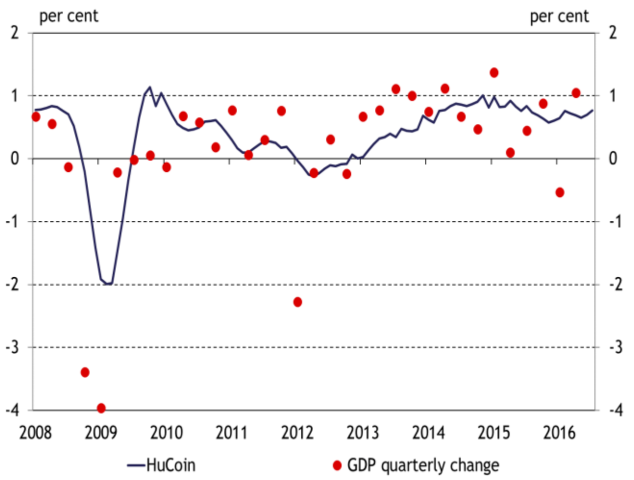


Note: Weighted average of monthly production indicators (industrial output, construction output and retail sales). The weights are derived from regression explaining GDP growth.
Source: MNB calculations based on HCSO data

On the expenditure side, GDP growth was boosted primarily by net exports and domestic demand for consumption items. Gross fixed capital formation continued to decline in the second quarter, which can be mainly attributed to the downturn in public sector investment financed from European Union funds. The growth in net exports resulted from several factors. In parallel with the recovery of industrial export performance, exports grew at a faster rate than in the previous quarter, while imports decelerated in line with the sharp fall in investment. Thanks to the remarkable performance of agriculture, changes in the inventories of the national economy made a positive contribution to growth.

Capturing domestic economic performance outlook over the medium term, the HuCoin indicator was generally stable considering the average of the past period (Chart 4).

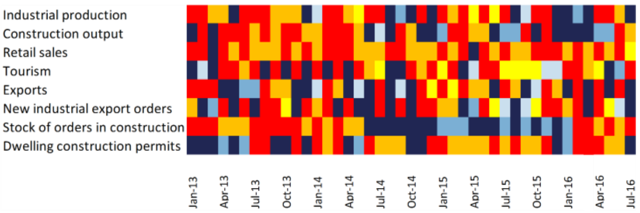
Chart 4: Evolution of the HuCoin indicator



Note: The historic values of the HuCoin indicator may have been changed by revisions to GDP data.
Source: MNB calculations based on HCSO data

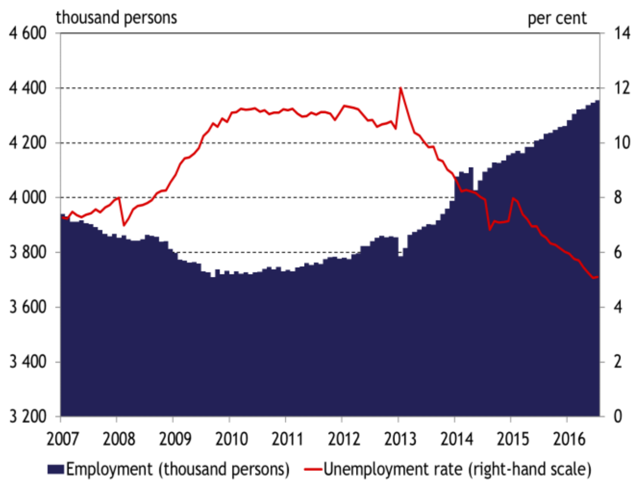
In July 2016, the volume of industrial output was down 4.7 per cent year on year and 0.4 per cent compared to the previous month on a seasonally adjusted basis. Production in the manufacturing subsectors indicated a negative picture. Output in the engineering industry – the sector representing the highest weight – decreased by 1 per cent compared to the previous month, while the performance of light industry, the chemical industry and the food industry also weakened. Only the metal industry showed an

Chart 5: Growth heat map



Note: 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.
Source: MNB calculations based on HCSO data

Chart 6: Number of persons employed and the unemployment rate



Source: HCSO

expansion compared to June. **On the whole, forward-looking indicators point to unfavourable developments regarding the short-term outlook of the domestic industry.**

Based on preliminary data, expressed in euro terms, the value of exports and imports decreased by 5.2 per cent and 6.0 per cent, respectively, in July 2016 year on year. The trade surplus was up EUR 24 million from last July. Although to a lesser degree than in previous months, in June 2016 the terms of trade continued to improve.

In July 2016 **the volume of construction output was down 17.6 per cent year on year,** while output fell by 3.2 per cent compared to the previous month. With opposing developments in the new contracts of the two main construction groups, the volume of new contracts fell somewhat short of the level observed last year; the volume of new contracts for the construction of buildings rose by 88.2 per cent, while other construction fell by 41 per cent. Besides contracts concluded for the construction of residential buildings, the rise in the volume of new contracts for the construction of buildings was driven by the construction of industrial, education and research buildings. At the end of July, the volume of new contracts concluded by construction companies exceeded the low base of the previous year by 16.6 per cent.

Based on preliminary data, **the volume of retail sales was up 2.7 per cent year on year** and 3.8 per cent based on data adjusted for calendar effects, while turnover dropped by 0.1 per cent compared to the previous month. As regards the structure of sales, sales volume increases were registered across a wide range of products.

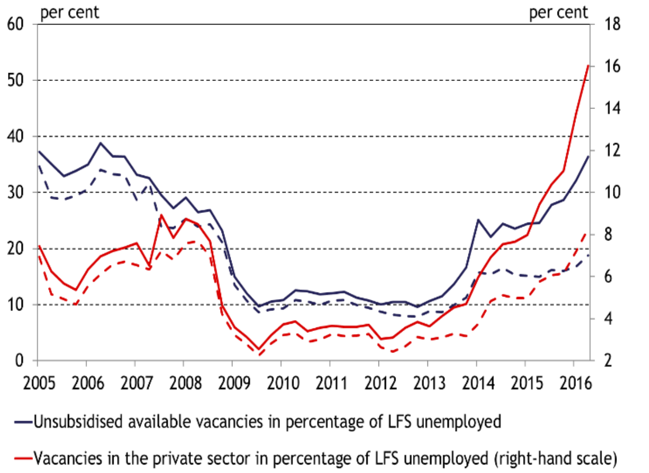
1.2.2. Employment

According to Labour Force Survey data, **in July 2016 the number of employees in the national economy increased by 2.9 per cent year on year.** While unemployment remained largely unchanged, similar to previous quarters, the labour force participation rate continued to increase. In July the unemployment rate stood at 5.2 per cent (Chart 6).

In the second quarter the number of employees in general government increased slightly relative to the previous quarter, which was attributable to the rise in the number of public workers to the level seen at the end of the previous year. Within the private sector, the dynamic increase in workforce continued, in particular, in the market services sector.

According to data released by the National Employment Service (NES), **there was no substantial change in the number of newly announced non-subsidised jobs** in July

Chart 7: Indicators of labour market tightness



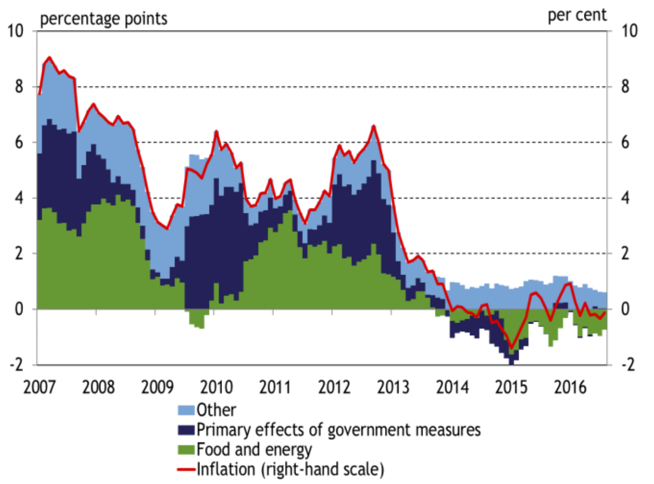
Note: The dotted line marks labour market tightness indicators adjusted for public workers.
Source: National Employment Service, HCSO

2016, while the end-of-month number of vacant non-subsidised jobs fell slightly, although it is still at a historic high in respect of the post-crisis period. In the second quarter the number of vacant jobs in the private sector published by the HCSO rose to another historic high. According to the tightness indicators calculated from various statistics, the gradual tightening observed in the labour market since 2013 continued (Chart 7).

1.3. Inflation and wages

In August 2016 year-on-year inflation was –0.1 per cent, while both core inflation and core inflation excluding indirect taxes stood at 1.2 per cent. Underlying inflation indicators remained unchanged and continue to point to a moderate inflation environment. In the second quarter of 2016 there was no change in annual wage growth in the private sector compared to the previous quarter, thus wage dynamics remained stronger than the growth observed in the previous year.

Chart 8: Decomposition of inflation



Source: MNB calculations based on HCSO data

1.3.1. Wage setting

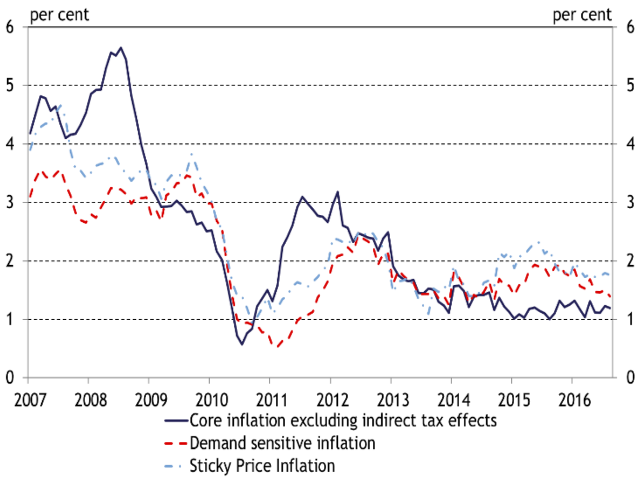
In the second quarter of 2016, the annual growth of gross average wages remained unchanged in the private sector compared to the previous quarter, **thus wage dynamics continue to outstrip the growth observed in the previous year.** According to seasonally adjusted data, gross average wages rose by 5.1 per cent year on year in the private sector. Regular wages remained unchanged compared to the previous month. The private sector saw moderating wage dynamics both in manufacturing and in the market services sector relative to the previous month.

Inflation developments

In August 2016 inflation was –0.1 per cent, while both core inflation and core inflation excluding indirect taxes stood at 1.2 per cent (Chart 8). Inflation rose primarily as a result of the increasing annual index of fuel products stemming from a base effect.

Underlying inflation indicators continue to point to a moderate inflation environment, reflecting, for the most part, low imported inflation and moderate commodity prices (Chart 9). In July 2016 agricultural producer prices

Chart 9: Measures of underlying inflation



Source: MNB calculations based on HCSO data

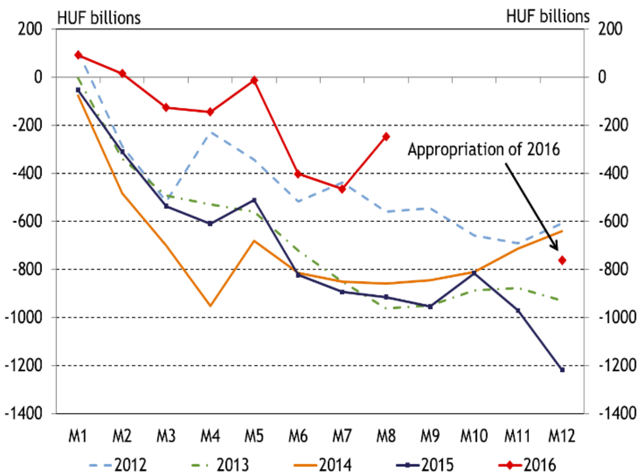
rose by 1.2 per cent in annual terms, while the domestic sales prices of consumer goods sectors rose slightly.

According to our current forecast, inflation may remain below the 3 per cent target both this year and next year, and it only gets close to it by mid-2018. Partly as a result of base effects, inflation may gradually increase looking ahead.

1.4. Fiscal developments

The general government's central subsystem closed with a historically favourable balance in August 2016. In the first eight months of the year, the cumulated cash deficit of the central budget was lower than at any other time in recent years.

Chart 10: Intra-year cumulative cash balance of the government budget



Source: MNB calculations based on HCSO data

In August 2016 the general government's central subsystem closed with a surplus of HUF 191 billion, representing a historically favourable balance. Outstripping the balance recorded in last August by HUF 220 billion, the balance surplus can be partly attributed to HUF 70 billion collected in growth tax revenues and partly to a revenue of HUF 150 billion from the theretofore debated European Union grant for the Social Renewal Operational Programme. **In the first eight months of the year, the cumulated cash deficit of the central budget was HUF 274 billion, the lowest figure recorded in recent years** (Chart 10).

In August 2016 **the tax and contribution revenues of the central sub-sector** exceeded the revenues of August 2015 by HUF 69 billion. The difference can be primarily linked to the payment of corporate income taxes, social contribution taxes and individual contributions.

In August 2016 the **expenditures of the central sub-sector** fell short of those in August 2015 by HUF 143 billion. The decline since last August can be mainly attributed to net expenditures related to EU transfers.

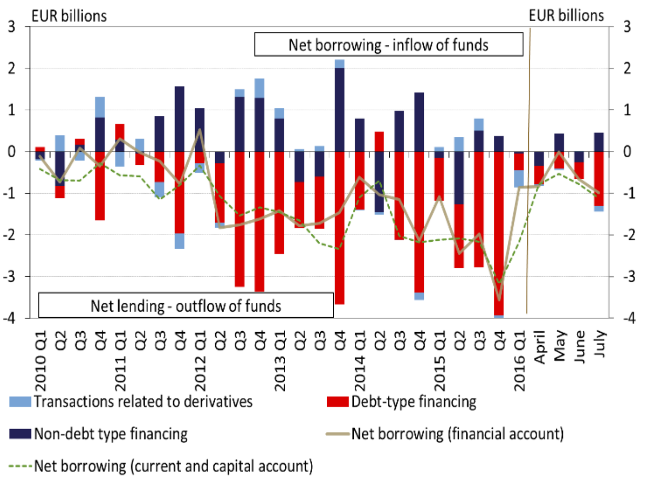
1.5. External balance developments

According to preliminary monthly data, the seasonally unadjusted net lending of the economy continued to rise and amounted to more than EUR 1.1 billion in July. The increase in net lending reflected, for the most part, the increased utilisation of EU transfers compared to previous months. Based on financial account data, net lending increased in the context of external debt repayment in excess of the previous month and a substantial expansion in foreign direct investment.

According to the July data release, the seasonally unadjusted net lending rose to EUR 1,120 million, which continues to comprise a significant, EUR 782 million current account surplus, but the increase in net lending resulted from the balance of the capital account, which rose to EUR 337 million. The higher surplus of the capital account is mainly due to the increased payment of EU transfers.

Net lending also increased (reaching approximately EUR 980 million) on the basis of financing side developments, with the increment resulting from a larger fall in external debt and an upward drift in foreign direct investment (Chart 11). The inflow of non-debt type liabilities was achieved through a more than EUR 600 million increase in net foreign direct investment, which reflected an upward shift in reinvested earnings and equity investment, partly in relation to the capital injection of Erste Bank. Net external debt decreased further by EUR 1.3 billion, mainly resulting from the reduction of the net external debt of the consolidated general government and of the banking sector. The decline in the net external debt of the consolidated general government was mainly due to the increased utilisation of EU transfers in comparison to the previous months. The decline in the net external debt of the banking sector was the combined result of an increase in the sector's external assets and a more moderate upward shift in its external debt.

Chart 11: Structure of external financing (unadjusted transactions)



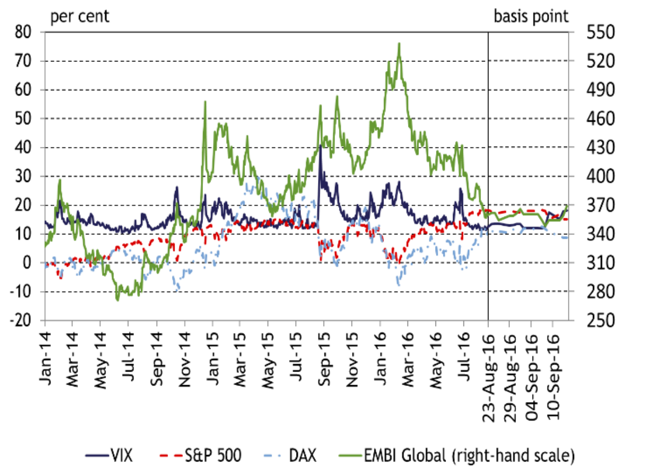
Source: MNB

2. FINANCIAL MARKETS

2.1. International financial markets

Market sentiment has varied since the latest policy decision and deteriorated significantly in the past week. Main stock market indices faltered, mostly owing to the statements issued by Fed policymakers at the end of the period, with a parallel increase in stock market risk indices. Oil prices dropped to USD 43–44 from the initial level of USD 48, representing a decline of around 10 per cent. Slightly deteriorating investor sentiment pushed long-term yields upward. On the whole, the tone of the major central bank's messages shifted towards a moderate degree of tightening.

Chart 12: Developed market equity indices, the VIX index (left-hand scale) and the EMBI Global Index (right-hand scale)



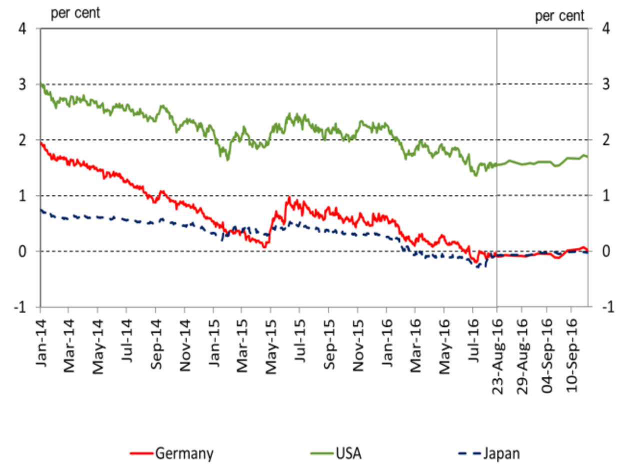
Source: Bloomberg

Market sentiment has varied since the latest policy decision and deteriorated significantly in the past week (Chart 12). The deterioration was reflected in the rise of developed market risk indices, in the fall of stock markets and in a general increase in yields. The shift can be mainly attributed to slightly tighter tone of communications by the Fed and the ECB. Money and capital markets were surprised rather negatively by both US and European macro data. In the case of the former, the unusually poor ISM Manufacturing Index and the worse-than-expected employment statistics should be highlighted. As regards the euro area, deteriorating confidence indices and unexpectedly low inflation data – the most critical information relevant to the ECB – played the most important role. Besides the central banks' slightly more stringent stance, the problems of European Union periphery countries came into focus again (Italian banking sector, the credit rating of Portugal, political and fiscal risks in Spain).

Developed stock market indices faltered mostly owing to the statements of Fed policymakers issued in the last week of the period. The stock market indices of developed European countries declined typically to a lesser degree (1–3 per cent) than the US indices (2–3 per cent), primarily as a result of intensifying expectations about an interest rate increase overseas. Stock market indices in emerging equity markets showed a mixed picture: the performance of stock markets was slightly positive in the region, while they performed more negatively in other emerging markets. On the whole, the MSCI composite stock price index of emerging markets declined by 2.4 per cent compared to a nearly 2.7 fall in the developed market MSCI index.

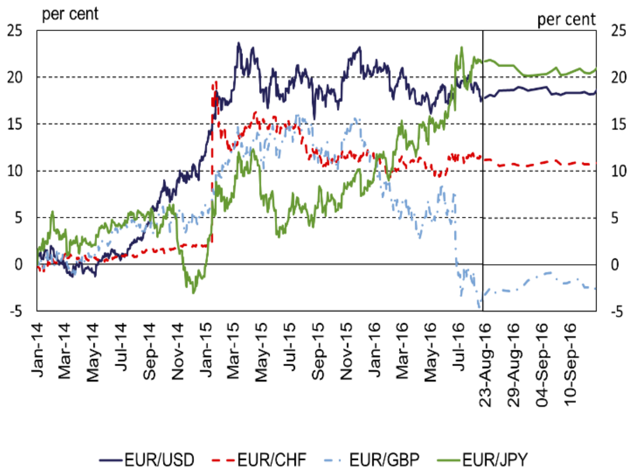
After moderate fluctuations, risk indices rose in the past week. The VIX index rose to almost 18 per cent from the initial 12.5 per cent, while the EMBI Global bond spread increased by 10 basis points. The MOVE index, measuring the volatility of the US bond market, remained largely unchanged. **Oil prices fell by 10 per cent from their initial level in the vicinity of USD 48 to USD 43–44 during the period.** The Bloomberg composite commodity indices (agriculture, energy and metal) also showed a decline (of 2–6 per cent). The fall affected the energy segment primarily,

Chart 13: Yields on developed market long-term bonds



Source: Bloomberg

Chart 14: Developed market FX exchange rates



Source: Reuters

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

but even the composite index of agricultural products dropped by 4 per cent.

The slightly deteriorating investor sentiment pushed long-term yields upward. The increase in yields was also supported by moderating expectations about the ECB's continued monetary easing and by the heightened probability of the Fed's interest rate increase (Chart 13). US, German and Japanese 10-year yields rose by 16, 14 and 4 basis points, respectively. The European periphery and the Visegrád region saw a comparable increase in long-term yields.

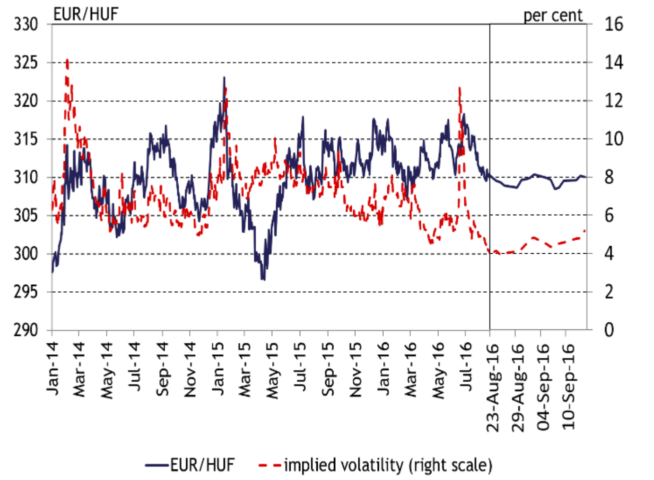
Of the major currencies, the period was dominated by the slight strengthening of the dollar mainly in relation to monetary policy announcements and disclosures (Chart 14). The dollar appreciated and the EUR/USD approached the 1.12 mark, while the Japanese yen depreciated by 2.2 per cent against the dollar, which can be interpreted as an adjustment following the previous strengthening of the yen.

According to market expectations, the probability of the Fed's interest rate increase by the end of the year increased slightly (the rate hike is priced in with a probability of 20 per cent by September and with a probability of just above 50 per cent by December). Despite worse-than-expected macro data, several Fed policymakers hinted at an imminent interest rate hike in their statements, which spurred negative market sentiment overall, although statements by other central bankers muddled the picture somewhat. **Mario Draghi's press conference also dampened expectations about the ECB's potential easing of its monetary policy stance, while 5x5 forward inflation expectations – which are of key importance for the euro area – remained unchanged, stagnating at a level of around 1.32 per cent.**

2.2. Developments in domestic money market indicators

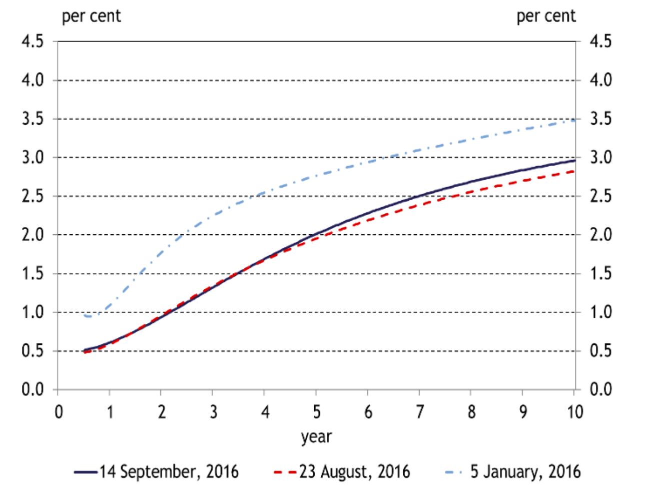
The risk assessment of Hungarian assets remained stable in the review period. With minor volatility, the EUR/HUF exchange rate remained largely unchanged throughout the month, while the longer end of the government bond market yield curve shifted upward by a few basis points. Non-residents' government securities holdings rose by HUF 90 billion.

Chart 15: EUR/HUF exchange rate and the implied volatility of exchange rate expectations



Source: Bloomberg

Chart 16: Shifts in the spot government bond yield curve



Source: MNB, Reuters

Domestic asset prices remained stable in the past few weeks; the slight deterioration in global sentiment had no perceivable effect on asset prices across the region. During the period, the EUR/HUF exchange rate moved within a fairly narrow band between 308 and 310.5, and did not change markedly throughout the entire period (Chart 15). Regional currencies showed a mixed trend: the forint, the Romanian leu and the Czech koruna essentially stagnated, while the Polish zloty weakened by 1 per cent during the period. Domestic data releases did not affect the exchange rates considerably; even the slightly negative August inflation data failed to prompt a shift in the foreign exchange market. The volatility of the forint exchange rate remained, as in previous months, at historical low levels.

The government securities market yield curve exhibited only minor shifts during the period: in line with developed market yield increases, a 5–10 per cent basis-point increase could be observed mainly on the longer end of the yield curve, while movements in the short and medium segments of the yield curve remained marginal (Chart 16).

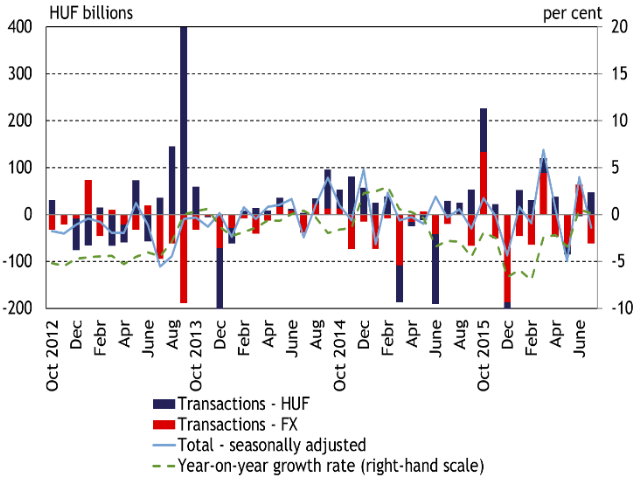
Demand at the bond auctions of the period was mostly strong, but in some cases (at the auctions of the 12-month discount Treasury bill and the 3-year bond) the Government Debt Management Agency's issuance of government bonds fell short of the announced quantity. Owing to heightened demand there was extra issuance for 5 and 10-year maturities. While average yields rose somewhat compared to the auctions of the previous period, the yields on 3-month discount Treasury bills and 10-year bonds remained essentially unchanged (0.39 and 2.93 per cent, respectively).

Non-residents' holdings of government securities have increased by HUF 90 billion since the last policy decision; as a result, their portfolio rose to HUF 3,665 billion during the period. The share of non-residents' holdings of HUF government securities edged up by 1 percentage point to 26.3 per cent. Consistent with regional trends, by the middle of the period the Hungarian 5-year CDS spread fell to its 1.5-year trough – to the vicinity of 125 basis points – before it adjusted somewhat upwards at the end of the period.

3. TRENDS IN LENDING

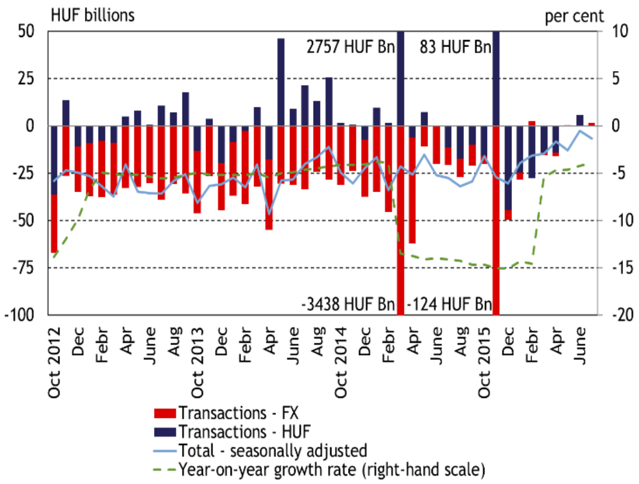
In July 2016 the corporate portfolio of credit institutions contracted, while loans outstanding in the household segment increased. Even after a slight increase in July, lending rates remained at low levels in the corporate sector and in the household segment.

Chart 17: Net borrowing by non-financial corporations



Source: MNB

Chart 18: Net borrowing by households



Source: MNB

As a result of transactions, **the outstanding loans of credit institutions to the corporate sector decreased by HUF 15 billion in July,** equivalent to a decline of HUF 28 billion on a seasonally adjusted basis (Chart 17). In terms of currency denomination, forint loans rose by HUF 47 billion, while foreign currency loans contracted by HUF 62 billion during the month. At the end of July, the annual dynamics of total corporate lending stood at 0.2 per cent. Loan agreements concluded in the third phase of the Funding for Growth Scheme boosted the outstanding forint and foreign currency loan portfolio by HUF 24 billion and HUF 6 billion, respectively, in the review period.

Even after a slight increase in July, the interest rates on new corporate loans remained historically low. In the case of newly granted corporate loans, the average annualised interest rate on low-value forint loans rose by 0.12 percentage points to 4.30 per cent from June, while excluding money market transactions, the average interest rate on higher-value forint loans increased by 0.17 percentage points to 3.71 per cent.

In the household segment, the foreign-currency denominated portfolio increased by HUF 1 billion in July, while forint loans outstanding remained unchanged overall (Chart 18). During the month, the contraction in outstanding loans amounted to 3.9 per cent in annual terms. In the period under review, households concluded new loan contracts at a total value of HUF 94 billion, thus the average annual growth in new business volume was 41 per cent. That notwithstanding, the value of new issuance compared to the previous month declined in almost all product groups except personal loans.

The interest rates on newly disbursed household loans rose slightly in July, but they still remained below pre-crisis levels. The annual percentage rate of charge on forint denominated housing loans and home equity forint loans edged up slightly: the former increased by 0.02 percentage points to 5.73 per cent, while the latter rose by 0.10 percentage points to 7.21 per cent.