Macroeconomic and financial market developments

July 2015

Background material
to the abridged minutes of the
Monetary Council meeting
21 July 2015

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The background material 'Macroeconomic and financial market developments' is based on information available until 17 July 2015.

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

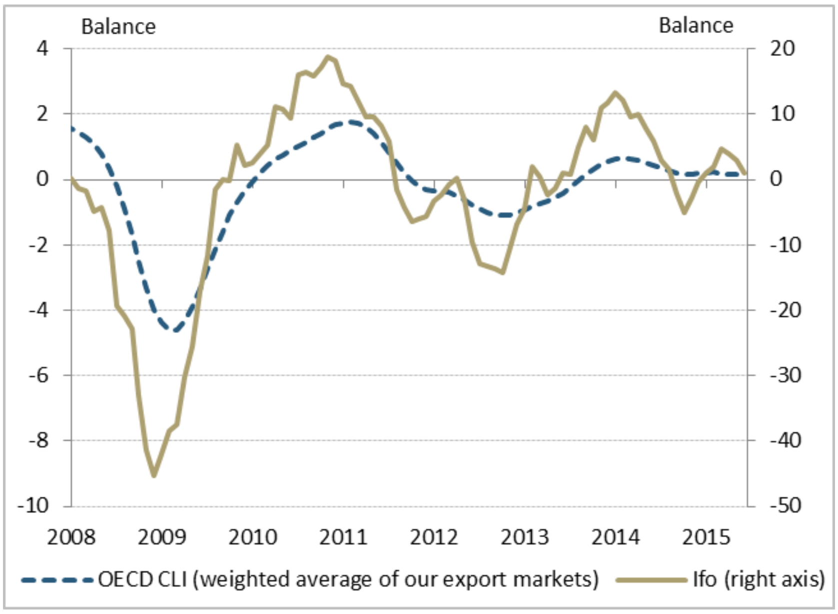
1.1. Global macroeconomic environment

GDP data for the first quarter of 2015 were in line with expectations in Hungary's export markets; thus the outlook for growth this year may evolve in accordance with the previously expected dynamics. Growth remains fragile surrounded by both upside and downside risks. The outlook for growth in the world's emerging regions is moderate compared to pre-crisis levels. Persisting geopolitical tensions slow growth in developed countries through weaker demand and economic sanctions. The low oil prices may boost growth in oil-importing economies, while slowing inflation. Inflationary pressure from the world market has remained weak in recent months as a result of moderate oil prices.

Growth in the world economy continued in the first quarter of this year. Based on available data, growth was consistent with expectations; the highest growth was registered in the countries of the Central- and Eastern-European region. The adverse effect of the Russia–Ukraine conflict has continued to impede economic growth through weaker demand and economic sanctions.

The euro area economy registered a quarter-on-quarter growth rate of 0.4 per cent in the first quarter of 2015. The monthly production data received show a moderate upturn in the economic activity of the region. The forward-looking indicators of economic activity imply moderately improving performance. The tense geopolitical situation continued to have a negative impact on economic activity, which is restrained by the increasing insecurity and the bilateral economic sanctions. Nevertheless, economic expansion continued at the moderate rate seen in the previous quarters. Economic growth in Germany, Hungary's most important export partner, was sluggish in the first quarter. Domestic demand in Germany continued to grow, but external market activity may have been curbed by the Russia–Ukraine conflict and the slowdown in demand in Asia. Expectations concerning the German economy (Ifo) have declined gradually in recent months, but continue to stay at favourable levels (Chart 1). Overall, the average increase in new orders in the German industry was modest in the past months. Therefore, looking ahead, the slow improvement in business activity may continue.

Chart 1: Indicators of activity in Hungary's export markets

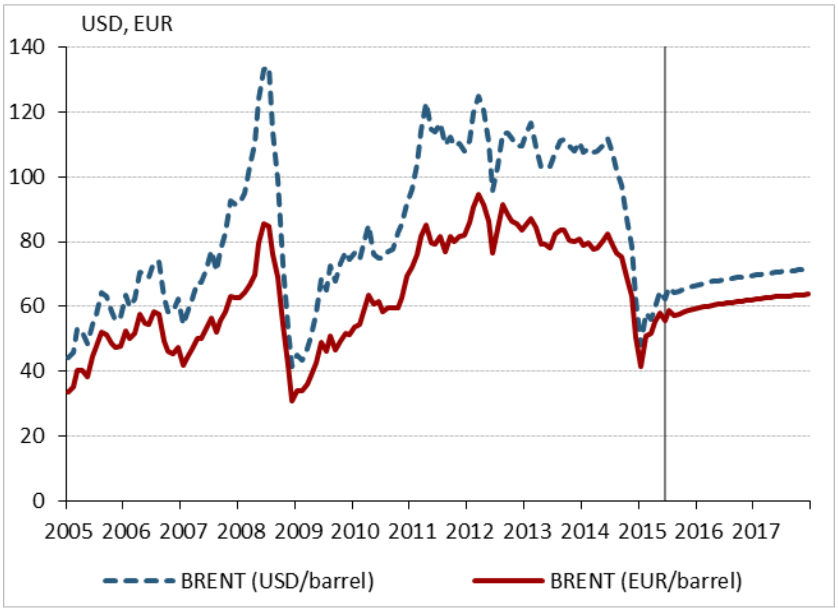


Sources: OECD, Ifo.

The performance of the region was outstanding in the first quarter of this year but, according to monthly indicators of recent months, industrial output is still fragile in the region. The negative effects of the Russia–Ukraine conflict may have had only a limited impact on growth in the CEE region so far, but looking ahead, the expected significant contraction in the Ukrainian and Russian economies may, both directly and indirectly, hinder economic growth in the region.

Inflationary pressure from the world market remains weak. Moderate commodity prices combined with slowly growing world economy are reducing inflation. As a result, inflation rates remain below target in the world's major economies (euro area inflation stood at 0.2 per cent in June). Oil prices declined in the past weeks. Consequently, on the whole, oil prices remain subdued, which, in addition to the increased supply, may be a result of the weak demand experienced due to the slowdown in growth of mainly the major importer countries (Chart 2).

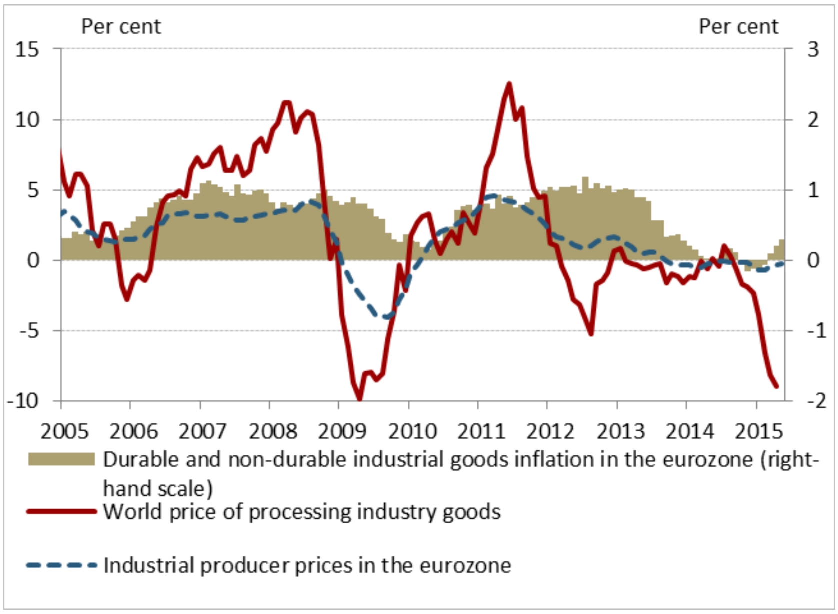
Chart 2: World market price of Brent crude oil



Source: Bloomberg.

The world market prices of industrial commodities, unprocessed food and manufactured goods continued to be depressed (Chart 3).

Chart 3: Industrial producer prices and tradables inflation in the euro area and world market prices of manufactured goods



Sources: Centraal Planbureau (www.cpb.nl), Eurostat, ECB.

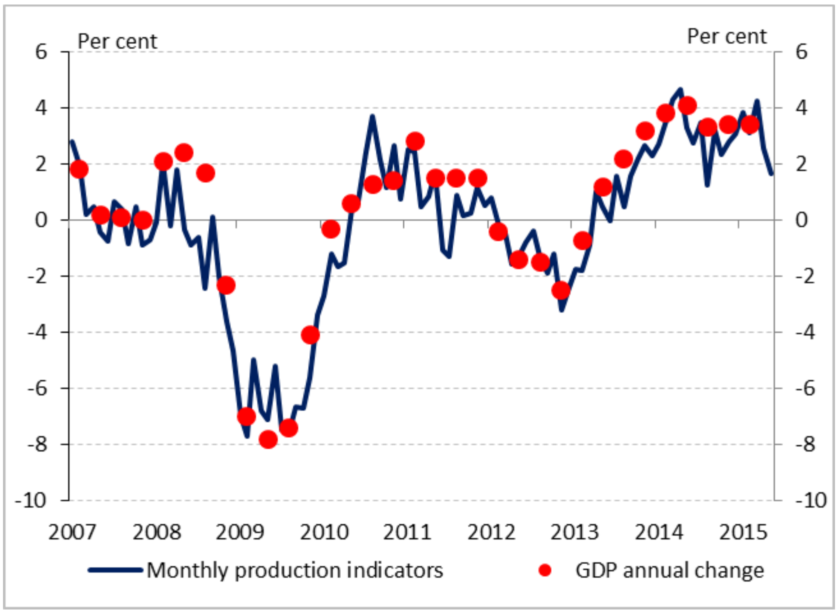
1.2. Domestic real economic developments

1.2.1. Economic growth

The Hungarian economy continued to grow in the first quarter of 2015. Hungary's GDP was up 3.5 per cent year-on-year, with a 0.8 per cent growth recorded relative to the previous quarter.

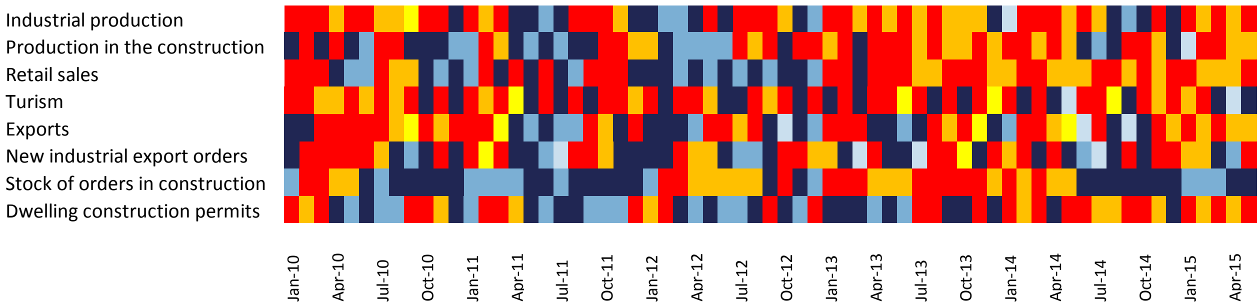
The manufacturing sector and services were the most important contributors to GDP growth. The increase in value added in the manufacturing sector was still linked primarily to the increasing production of vehicle manufacturing and the related subsectors, while the expansion observed in a wide range of market services was boosted by recovering domestic demand. Construction still had a positive contribution to growth, albeit to a lesser extent than seen in the previous quarters. The estimated contribution of agriculture was negative in the first quarter due to the high base from last year's favourable harvest. The HCSO estimated the value added by the sector in the first quarter based on technical assumptions; the final data will be determined depending on the harvest results of the next quarter.

Chart 4: Changes in monthly production indicators and GDP*



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

*Chart 5: 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. Source: MNB calculations based on HCSO data.

In May 2015, industrial output rose by 1.5 per cent year-on-year. Seasonally adjusted production level excluding the working day effect was **0.5 per cent down compared to the previous month.** The performance of manufacturing subsectors showed a mixed picture. Food industry and vehicle manufacturing output increased, while production in the chemical and metal industries declined compared to the previous month. Looking ahead, the picture is varied. The Ifo confidence index related to German industrial production weakened in the past months. At the same time, forward-looking indicators of domestic underlying developments continued to be favourable. Overall, the gradual pick-up in the euro area may continue in the coming months. It may be supported by moderate oil prices and the loose monetary policy of the ECB, but may be negatively affected by the Russia–Ukraine conflict and the impact of the sanctions extended until next January.

Denominated in euro, in May the **value of exports increased by 2.5 per cent**, while **imports declined by 0.7 per cent, year-on-year**. The trade surplus exceeded its value registered in May last year. The terms of trade were stagnant, with export and import prices declining at nearly the same rate.

In May 2015, **the volume of construction output rose by 2.3 per cent year-on-year**, while seasonally and working-day adjusted **output fell by 3.1 per cent compared to the previous month**. The fall in the construction of buildings may mainly be attributable to the high base one year earlier and to the lack of high-value new investment. The performance of the sector is expected to be subdued during 2015, indicated by the steady decline in the book of contracts for nearly one year and the high base of last year. Approaching the end of the 2007–2013 EU programming period, infrastructural projects financed from EU funds may fade away in the course of the year.

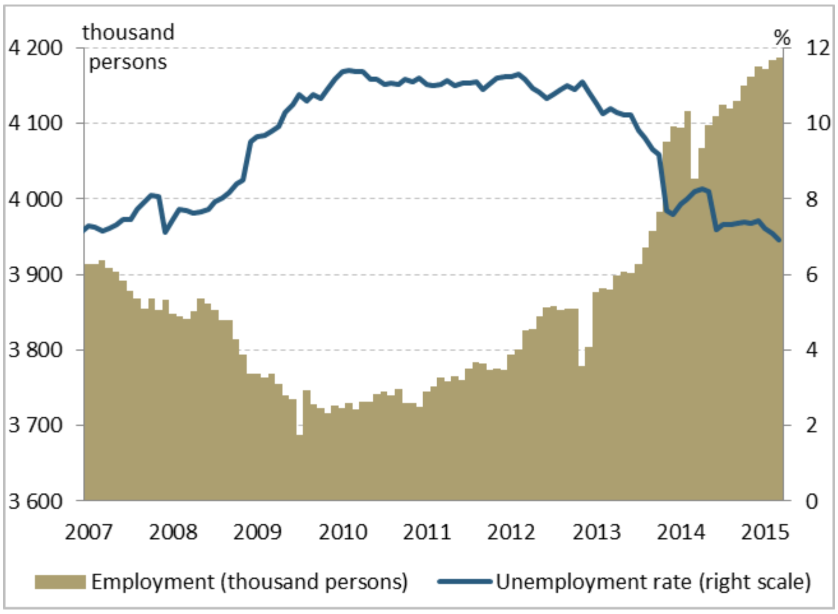
Consumption demand expanded further in the first quarter of this year and this trend may have continued in the second quarter as well. This may be explained by the increase in real wages as a result of the improving labour market situation and low inflation, as well as by the upswing in retail sales volumes. According to preliminary data, retail sales continued to rise in May, exceeding the level observed in the same period of last year by 5.5 per cent. Based on the structure of sales, turnover may have increased in a wide range of products in May. Following stagnation in April (which may have been explained mainly by a base effect), moderate growth was observed in the sale of foodstuffs in May. The sales of non-food consumer durables have materially increased year-on-year and made a major contribution to the rise in retail sales volume. Fuel sales continued to increase in May, but the rate of expansion is below the annual dynamics seen earlier, which may also be attributable to the effect of the high base of the previous year. Oil prices and thus the demand increasing effect of declining fuel prices may already have contributed to the increase in retail sales in a wider range of products as well.

The baseline projection in the June Inflation Report indicates the continuation of a structurally balanced economic growth, and in addition to a further increase in consumption and investment, net exports may also significantly contribute to the expansion of the economy in 2015. The economy grew by 3.6 per cent in 2014 as a whole, which may be followed by an expansion of over 3 per cent this year as well. Economic growth this year may be supported by the recovery in domestic demand, the absorption of EU funds, loose monetary conditions and the improving labour market conditions. Although moderate oil prices may boost growth in EU Member States, the protracted Russia–Ukraine crisis and the declining growth in Russia and Ukraine may point to a deceleration.

1.2.2. Employment

According to Labour Force Survey data, **in May 2015 the number of employees in the national economy increased by 4.4 per cent year on year**. In parallel with the stagnation in activity, the **number of unemployed continued to decline in May** (Chart 6). As a result, the unemployment rate fell to 6.7 per cent.

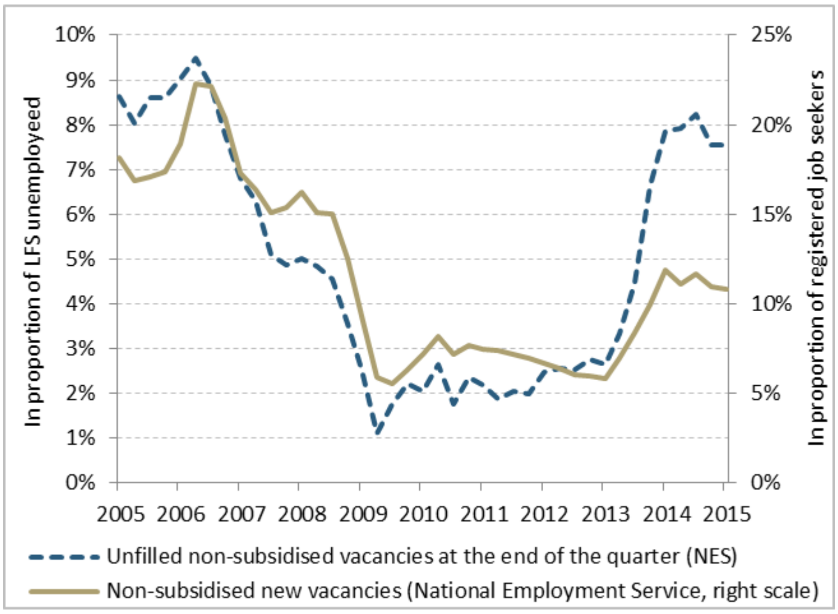
Chart 6: Number of persons employed and the seasonally adjusted unemployment rate



Source: HCSO.

In April, both the number of newly announced and vacant, non-subsidised jobs declined compared to the previous month. The labour market continues to be tighter than it was at the beginning of 2013 (Chart 7).

Chart 7: Indicators of labour market tightness



Sources: HCSO (Labour Force Survey), National Employment Service.

1.3. Inflation and wages

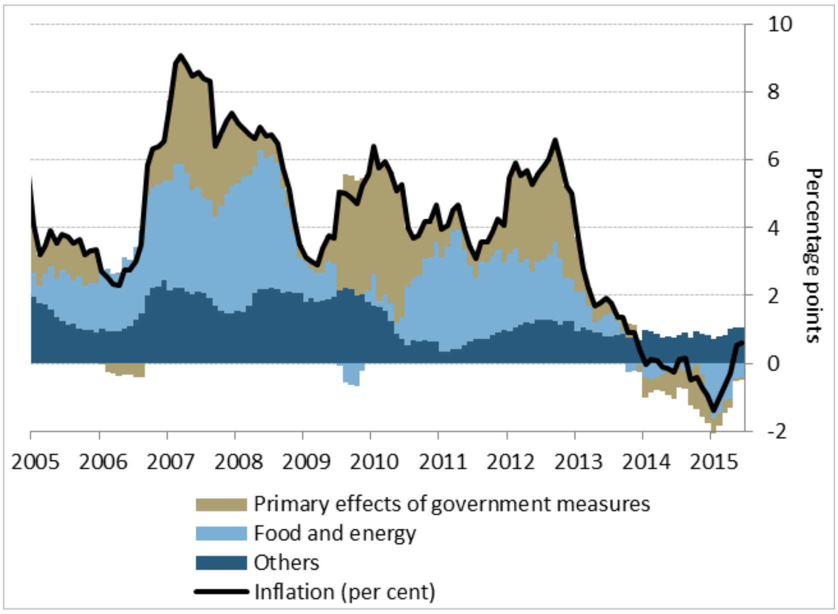
1.3.1. Wages

Gross private sector wages rose by 4.1 per cent in April compared to the same period of the previous year. A pick-up in wage dynamics was observed both in manufacturing and the market services sector.

1.3.2. Inflation developments

In June 2015, inflation was 0.6 per cent, while core inflation was 1.3 per cent and core inflation excluding indirect taxes stood at 1.2 per cent (Chart 8). Total inflation and annual price indices in the majority of groups changed only slightly compared to May.

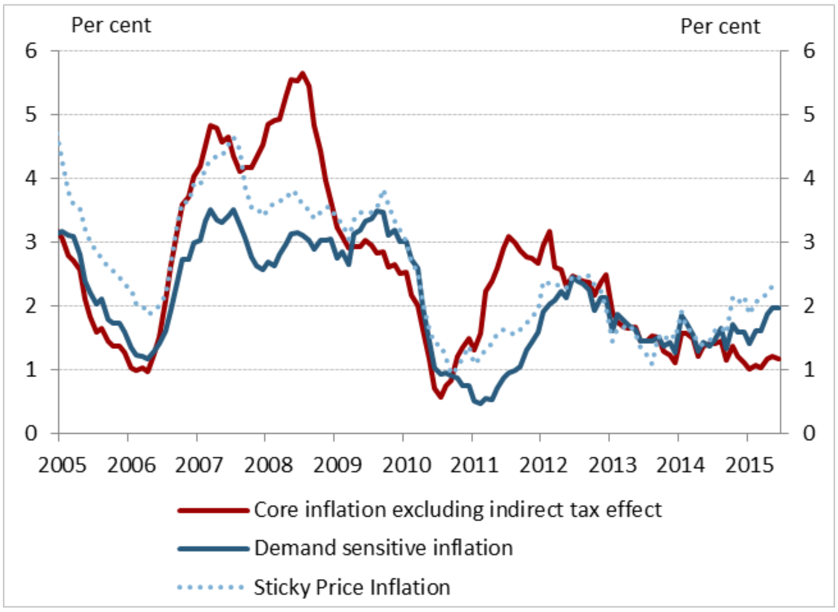
Chart 8: Decomposition of the consumer price index



Source: MNB calculations based on HCSO data.

Moderate oil prices, low inflation expectations and moderate imported inflation may all have contributed to the restrained inflation in recent months (Chart 9). In May 2015, agricultural producer prices fell by 8.1 per cent in annual terms, while the domestic sales prices of the consumer goods sectors remained unchanged relative to the same period of the previous year. In June, fuel prices rose slightly compared to the previous month. Consumption demand, in line with retail trade data, may have continued to expand during the second quarter, in parallel with the year-on-year rise in real income. The volume of retail sales still remains below pre-crisis levels. Consequently, the domestic demand environment may continue to exert a disinflationary impact overall, although this effect is gradually fading.

Chart 9: Measures of underlying inflation



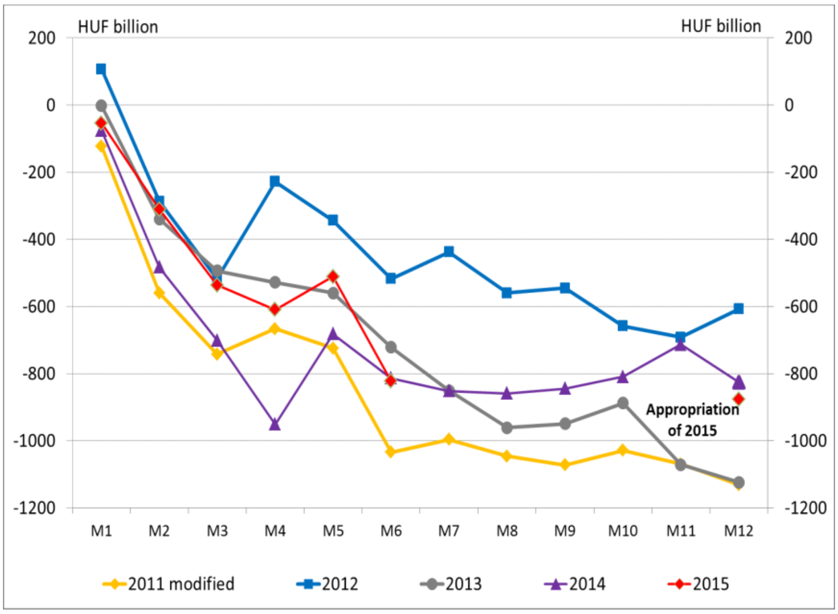
Source: MNB calculations based on HCSO data.

Inflation may remain in a slightly positive domain in the short term. The data received for June were practically in line with the expectations in the June Inflation Report. Looking ahead, in parallel with some, although moderate cost effects and the pick-up in demand, the inflation rate is expected to increase further.

1.4. Fiscal developments

In June 2015, the state budget recorded a deficit of HUF 312 billion, which is HUF 150 billion greater than the average of the previous three years (Chart 10). In June 2015, the revenues of the central subsystem of the general government were up by HUF 31 billion compared to the 2014 base, which is mostly attributable to the increase in VAT revenues. Expenditures of the central subsystem exceeded the June 2014 value by HUF 222 billion. The increase in expenditures is primarily attributable to the net expenditures of the central budgetary institutions and chapters as well as to the interest expenditures.

Chart 10: Intra-year cumulative balance of the state budget



Source: Hungarian State Treasury.

1.5. External balance

According to the May data release, the seasonally unadjusted external financing capacity amounted to EUR 860 million, with surpluses of EUR 500 million and EUR 360 million in the current and capital accounts, respectively.

The financing capacity indicated by the financing data amounted to EUR 900 million, while the decline in debt continued in the structure of funding, and some net FDI inflows were also recorded. In May, just like real economy data, financing data also signalled a similar degree of financing capacity. Moderate net FDI inflows were observed in April and May . At the same time, outflows of debt-type funds continued, determined by the decline in forint-denominated government securities held by non-residents; accordingly, there was a major decline in external government debt. In parallel with that, the banking sector's net external debt increased slightly, while that of the corporate sector continued to decline.

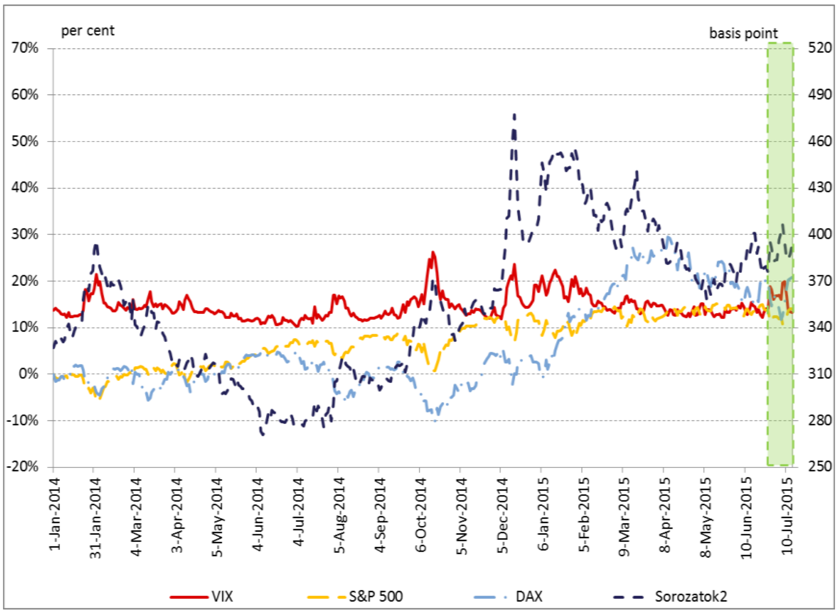
2. FINANCIAL MARKET DEVELOPMENTS

2.1. International financial markets

In the period since the last interest rate decision, investor sentiment has deteriorated on the whole, money market volatility has increased, equity indices fell and emerging foreign-exchange rates depreciated against the dollar. In Europe, in spite of the fact that the majority of market participants expected only a slight money and capital market effect of the developments in Greece, the unfolding events proved to be market-moving during the month. In the USA, despite mixed labour market data, a basically improving picture is taking shape. At the same time, the uncertainty concerning the Fed's interest rate path remained: at present, it is being debated in the markets whether one or two interest rate hikes will take place this year. Based on market pricing, an interest rate hike in December seems to be the most probable outcome, although tightening may even start as early as September according to analysts' views. The minutes of the June meeting of the FOMC indicated that the Fed is also concerned with the possible negative effects of the Greek crisis, which may have an impact on the US economy especially in terms of money market developments. Accordingly, the uncertainty related to Greece may be a new factor in the Fed's decision. The picture concerning the timing of the first interest rate hike did not become clearer following a recent speech of Fed Chair Janet Yellen either. Although it was balanced and did not contain anything new, it confirmed that interest rate hikes may already start this year, which resulted in the appreciation of the dollar. She told that in her opinion the labour market may be looser than what is indicated by the 5.3 per cent unemployment rate. At the same time, there are signs of an upswing in a number of areas, for example in the case of part-time employment or the activity rate. However, the growth rate of wages still does not show the expected signs of a pick-up.

The MSCI indices, measuring the performance of the developed and emerging equity markets, registered a decline throughout the period, where the fall was stronger in the case of the latter one. In Asia, the decline in emerging market stock exchanges was attributable to the selling pressure developing in China and resulting in a nearly 30 per cent fall of the Chinese stock exchange price index from its June high. The equity market situation was exacerbated by the extensive leveraged trading as well, resulting in a further increase in shareholders' losses. The fall in the Chinese stock exchange was felt in several countries of the Asian region, although rather due to growth concerns, and not as a consequence of direct contagion. At the end of the period, as a result of the agreement attained at the negotiations with Greece and the stabilisation of the Chinese equity market, a major improvement in mood and a significant increase in the exchange were observed. The EMBI Global Emerging Market Bond Index rose by 19 basis points since the previous interest rate decision, indicating that the assessment of emerging markets deteriorated only slightly last month in spite of the international pessimism (Chart 11).

Chart 11: Developed market equity indices, the VIX index (left axis) and the EMBI Global Index (right axis)



Source: Bloomberg.

The situation in Greece continues to be vulnerable. At the beginning of the period the chance of Grexit was considered low by market participants, but the probability of Grexit increased gradually as a result of several adverse developments, including the missed payment to the IMF, the sudden collapse of the liquidity position of the Greek banking sector, the introduction of capital controls and the refusal of the reform plan at the 25 June referendum. According to analysts, the agreement reached at the end of the period, almost at the last moment, means that Grexit can be avoided. At the same time it was emphasised by several of them that at this stage the Greek crisis was not over. Economic, financial and political prospects deteriorated considerably in the past months, as the introduction of capital controls entailed significant costs in all the sectors of the economy, and the deterioration of trust between the negotiating parties may render it more difficult to conclude the negotiations related to the 3-year ESM credit line. A possible confidence crisis of the Greek government may pose a further risk, since – as opposed to both their earlier election promises and the outcome of the referendum – they have to implement strict tightening required by the new agreement. At the same time, the Greek parliament voted for the introduction of prior actions required by the creditors, thus averting a major risk. Opinions on the economic effect of the tightening vary; many believe that the introduction of tightening measures may further deepen the Greek economic crisis. In the longer run, questions are raised by the problems of debt forgiveness, which may take place later following the first review of the Greek programme. However, this requires Greece to meet creditors' demands.

The escalation of the Greek problems triggered steps by all the three major credit rating agencies, taking Greece closer to a partial default. The sovereign Greek credit rating was downgraded by both S&P and Fitch by 1 grade (to 'CCC' by the former and to 'CC' by the latter), while Moody's downgraded the Greek sovereign credit rating from Caa2 to Caa3. In addition, S&P rated four large Greek banks as 'SD' (selective default) because of the introduction of the capital controls.

Macroeconomic data from the USA and the euro area varied in the period under review. Nevertheless, since the last interest rate decision the euro depreciated by more than 2 per cent against the dollar, so the EUR/USD cross rate sank below 1.10, reflecting the concerns related to the stability of the single European currency, which became endangered by the Greek crisis. Following the agreement with Greece in mid-July, again the diverging monetary policy stances of the Fed and the ECB dominated in the developments in the EUR/USD cross rate. In Europe, the retail trade turnover data released in the period for May and the June purchasing manager indices increased slightly, and indicated that economic growth may continue in a wide range of countries in the second quarter. In line with expectations, the June consumer price index declined by 0.1 percentage point to 0.2 per cent, which means that euro area inflation has been below half per cent for already a year. In accordance with expectations, the ECB left its policy rate unchanged at its rate-setting meeting in July.

In parallel with the strengthening in global risk aversion, developed market long-term yields declined at the beginning of the period, but adjusted later, so, on the whole, they remained practically unchanged during the month. The yield of the 10-year German Bund stands at 0.84 per cent; at the time of the previous interest rate decision it was traded at 0.87 per cent. UK and US yields also showed a mere 2–3 basis point shift. Yields were 15–40 basis points up in the euro area periphery, but later they adjusted back completely. Typically, a decline of 5–10 basis points was observed in the closer region of Hungary.

In addition to the generally negative atmosphere, several factors pointed to a decline in oil prices; accordingly, the prices of Brent and WTI oil fell by USD 7–9. Beside the fall in European oil demand due to a possible effect of the Greek crisis, Chinese growth concerns also surfaced, after Chinese households and companies had suffered serious losses in the Chinese stock exchange. The appreciation of the dollar may also have contributed to the decline in oil prices. The already high oil supply may be further increased by the agreement reached with Iran. Accordingly, the sanctions on oil exports will be reduced in return for restrictions on and control of the Iranian nuclear programme. The decline in US oil reserves at the end of the period resulted in an upward shift in oil prices. Nevertheless, oversupply continues to be expected at a global level.

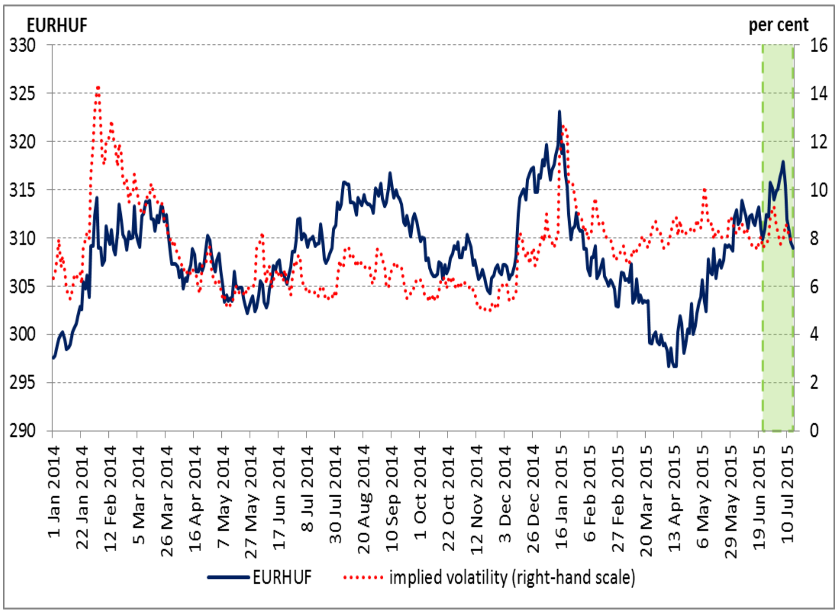
2.2. Developments in domestic money market indicators

Domestic money market sentiment was primarily determined by international factors during the period under review; country-specific impacts were less visible.

Following the previous interest rate decision the exchange rate of the forint was volatile in parallel with the change in global sentiment. However, it remained almost unchanged on the whole (Chart 12). EUR/HUF trading showed a continuous depreciation in the first half of the month, rising from around 310 to nearly 318, which was attributable to the unfavourable global investor sentiment. However, at the end of the month, as a result of more favourable news related to the agreement with Greece, the exchange rate of the forint also strengthened again to levels around 309. Compared with the regional currencies, the forint followed a similar path as the Polish zloty; however, due to the more moderate weakening of the Polish currency at the beginning of the period, the domestic currency slightly underperformed in the region, but recovered by the end of the month. In the period under review, the Czech koruna was an overperformer with its nearly 1.5 per cent strengthening, while there were no major changes in the exchange rates of other currencies in the region. In the past period, beside international factors, country-specific reasons had a slight impact on forint movements. The outstanding demand experienced at the MNB's preferential interest rate swap (IRS) auctions may have contributed to the appreciation of the forint at the end of the period, and speculations related to

Moody’s review may also have had a strengthening effect. At the same time, the June inflation figure, which was in line with expectations, did not affect the exchange rate.

Chart 12: EUR/HUF exchange rate and its implied volatility

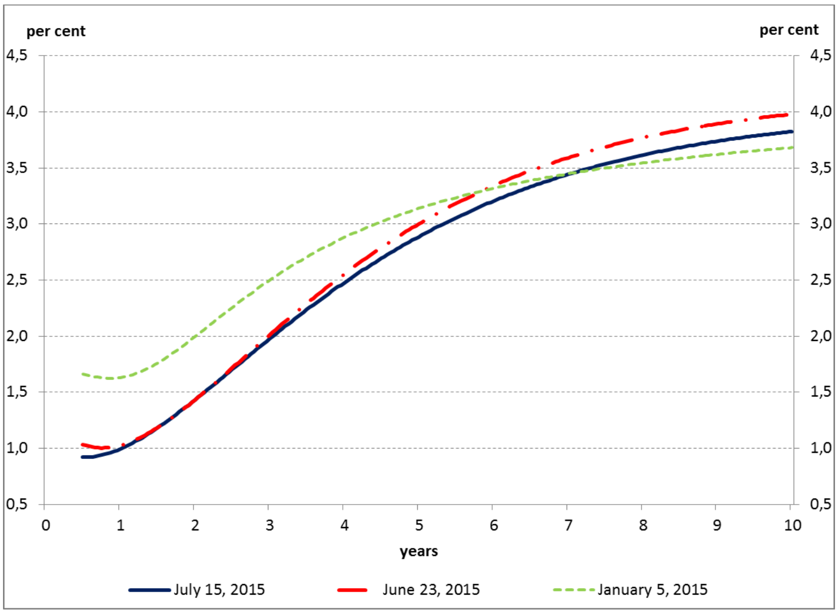


Source: Bloomberg.

The domestic macroeconomic data released in the period varied. The unemployment rate for the March–May period was a positive surprise for investors, while the June inflation figure was in line with expectations. The trade balance in May was more favourable than in April, but industrial production was slightly below expectations.

Hungarian government securities market yields typically declined in the period under review. In the secondary market of government securities there was a slight, 10–17 basis point decline in the yields for maturities of up to one year and a 3–4 basis point decrease in the yields in the 1–3 year segment. In the case of long-term yields, similarly to the maturities of up to one year, the decline was 15–16 basis points. The 3-month benchmark yield fell to 0.93 per cent, while the 10-year yield is below 4 per cent again, standing at 3.75 per cent. Short-term yields declined slowly and steadily, while the success of the MNB’s IRS auctions may also have contributed to the more pronounced decline in long-term yields. In parallel with a decline in long-term yields, due to a decrease in short-term yields, **the steepness of the government securities market yield curve has remained practically unchanged since the previous interest rate decision** (Chart 13).

Chart 13: Shifts in the spot government bond yield curve



Sources: MNB, Reuters.

Average yields declined at government securities auctions during the period. The average yield was down by 6 basis points at the auctions of both the 3-month and 12-month papers. In the past weeks there was a sound demand during the sale of discount treasury bills, with coverage varying between 1.5 and 2.5. There was also a strong demand at the auctions of the long-term fixed-rate securities; the coverage was more than double on each occasion, and the Government Debt Management Agency regularly increased the issued volume at the last auction of the 3-, 5- and 10-year securities. Average yields in the fixed-rate long-term segment have decreased by 5–30 basis points for all maturities since the last interest rate decision.

There was an extremely high demand of a total HUF 140.5 billion at the 3- and 5-year interest rate swap (IRS) tenders announced within the framework of the MNB’s self-financing programme. The whole amount was accepted. The strong demand experienced at the 5-year government securities auctions may have also been supported by the result of the central bank tender.

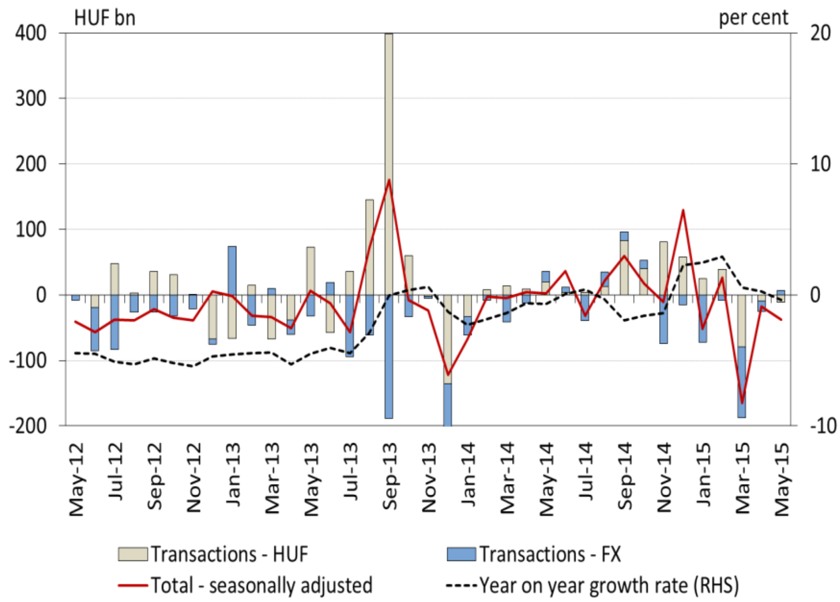
Last month, there was already only a slight decline in government securities holdings of non-residents. At present, non-residents hold Hungarian government securities roughly in the amount of HUF 4,460 billion, and thus their share declined to around 40 per cent. In spite of the low sales, domestic long-term yields declined similarly to the region in the period under review, and **there was no material change in the risk assessment of Hungary either**. **The Hungarian 5-year CDS spread fell by 4 basis points, standing around 147 basis points.**

3. TRENDS IN LENDING

In May, as a result of transactions, the outstanding loans by credit institutions to the corporate sector declined by a total HUF 5 billion (by HUF 38 billion, seasonally adjusted) (Chart 14). Forint loans fell by some HUF 12 billion, while foreign currency loans increased by nearly HUF 7 billion. The transaction-based annual growth rate fell from plus 0.2 per cent in April to minus 0.4 per cent. Loan contracts under Pillar I of the FGS contributed to corporate lending by HUF 34 billion in May.

In May, in the case of newly granted corporate loans, the average interest rates on both small- and high-amount forint loans declined.

Chart 14: Net borrowing by non-financial corporations

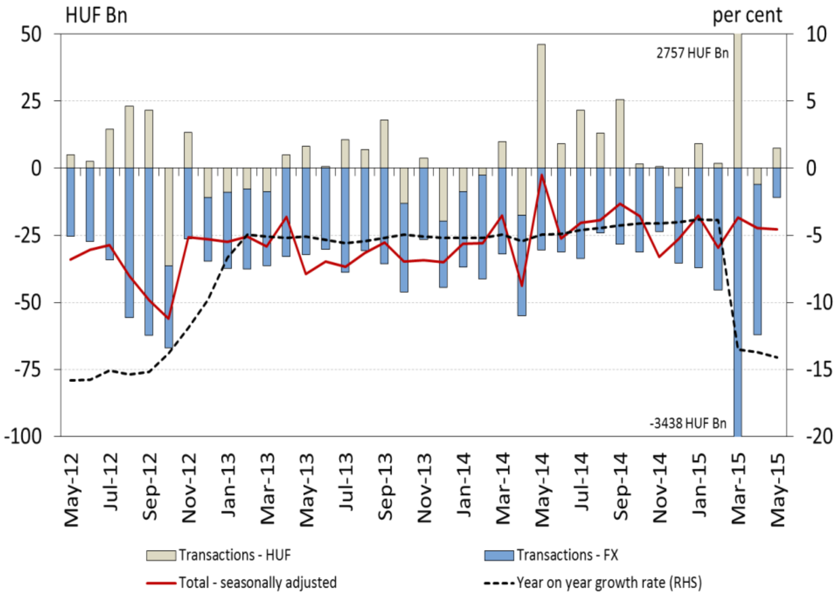


Source: MNB.

Outstanding loans to the households as a whole declined by HUF 4 billion as the result of loan transactions in May (Chart 15). Forint loans outstanding increased by HUF 7 billion, while total foreign currency loans fell by HUF 11 billion. The annual rate of decline in loans outstanding increased from 13.7 per cent in April to 14.1 per cent. On an annual basis, the expansion in new housing and vehicle loans granted in May continued to be intensive, while the issuance of general purpose and hire purchase loans remained practically unchanged. At the same time, the value of contracts declined to some extent in the case of personal and other loans.

Interest rates on new housing loans also continued to decline. The annual percentage rate of charge (APRC) on housing loans decreased by some 0.2 percentage points in May. The APRC on consumer loans also continued to decline; the average APRC on forint consumer loans to households fell from 18.98 per cent to 17.67 per cent in May.

Chart 15: Net borrowing by households



Source: MNB.