Macroeconomic and financial market developments

June 2016

Background material
to the abridged minutes of
the Monetary Council meeting
of 21 June 2016

Published: 2 p.m. on 6 July 2016

The background material 'Macroeconomic and financial market developments' is based on information available until 17 June 2016.

Section 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 background materials to the minutes are available on the MNB's website at:

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

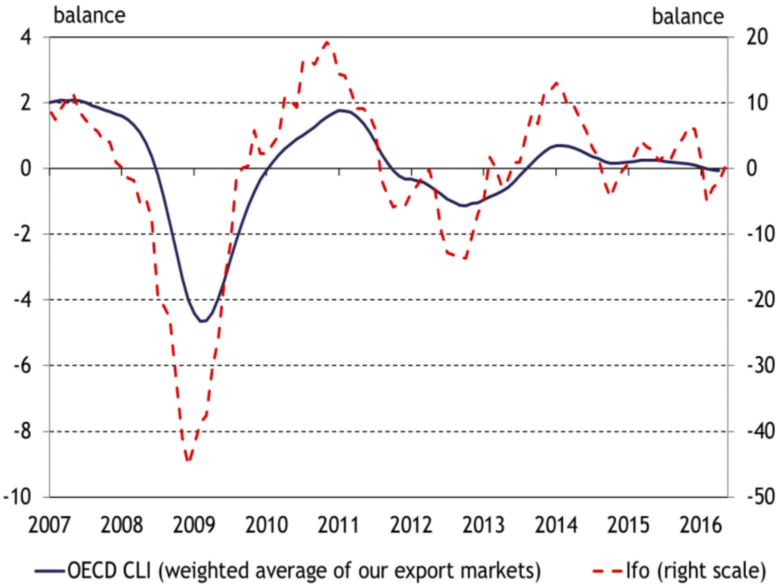
1. MACROECONOMIC DEVELOPMENTS

1.1. Global macroeconomic environment

The GDP figures for the first quarter showed a mixed picture. Growth in the USA and the euro area was weaker than analysts' expectations, while that of Germany was more favourable. Year-on-year, Japanese growth decelerated to around zero per cent. Looking ahead, global growth is expected to decelerate in the coming quarters. In its latest, April report, the IMF revised its growth outlook downwards for both developed and emerging countries. **Growth remains fragile surrounded primarily by downside risks.** Low commodity prices continue to drag on the growth of commodity exporters' economic activity, while persisting geopolitical tensions slow growth in developed countries through weaker demand and economic sanctions.

The euro area economy registered a quarter-on-quarter growth rate of 0.6 per cent in the first quarter of 2016. Growth may be negatively affected by the tense geopolitical situation: increasing uncertainty and bilateral economic sanctions may restrain economic activity. Economic growth in Germany, Hungary's most important export partner, continued to improve in the first quarter as well, supported by increasing domestic demand. By contrast, decelerating Asian demand dragged on German foreign trade, causing industrial performance to slacken compared to the previous months. The declining trend seen since last December in expectations concerning the German economy (Ifo) has broken, and a correction has been observed in recent months (Chart 1).

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

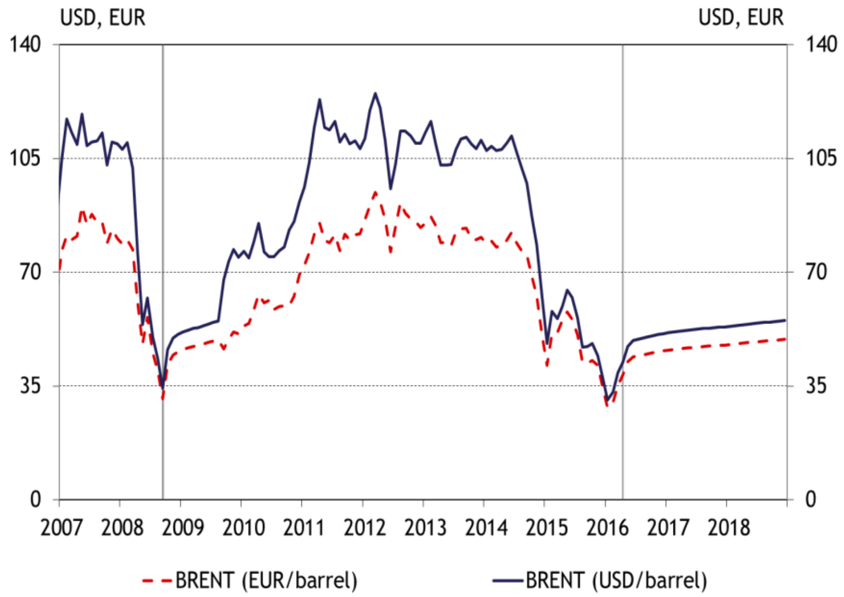


Source: OECD, Ifo.

The region kept up its good performance in the first quarter of 2016 as well. 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 carry both direct and indirect risks to economic growth in the region.

Inflationary pressure from the world market remains weak, due partly to historically low commodity prices, and partly to subdued demand. As a result, inflation rates remained below target in the world's major economies. In recent months, oil prices climbed over USD 50, falling at the end of the period (Chart 2; for more details see subsection 2.1).

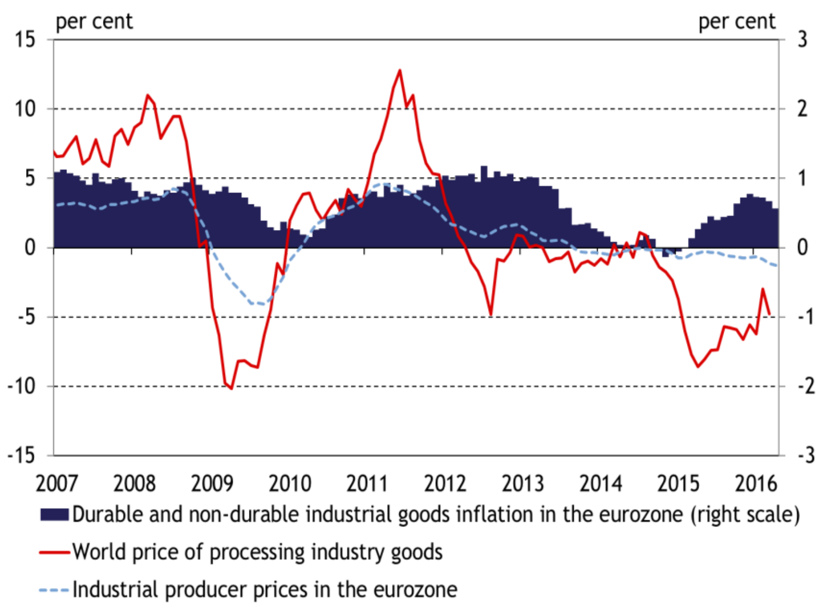
Chart 2: Monthly average world market price of the Brent crude oil



Source: Bloomberg.

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

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



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

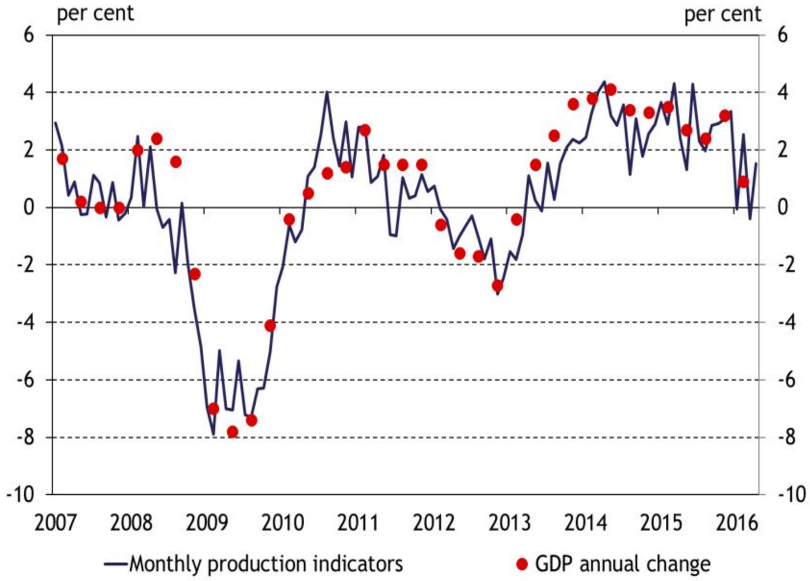
1.2. Domestic real economy developments

1.2.1. Economic growth

In the first quarter of 2016, Hungary's GDP grew at a rate of 0.9 per cent year-on-year, while compared to the fourth quarter of 2015 it fell by 0.8 per due to one-off effects (Chart 4). **Following the temporary subdued dynamics seen at the beginning of the year, a significant improvement in growth is expected.**

On the production side, the increase in the volume of market services accelerated, while slowing industrial production and a significant fall in construction decreased the rate of economic growth in the first quarter of 2016. Based on monthly data, in the first quarter the dynamic growth of industrial output seen in previous quarters was held back by temporary factory stoppages and Audi's reduced work week, with a correction in output in April. The production volume of the construction industry was significantly reduced, primarily due to the phasing out of projects financed from EU funds. By contrast, the volume of retail sales continued to increase in the first quarter of 2016.

Chart 4: Monthly production indicators and GDP growth*

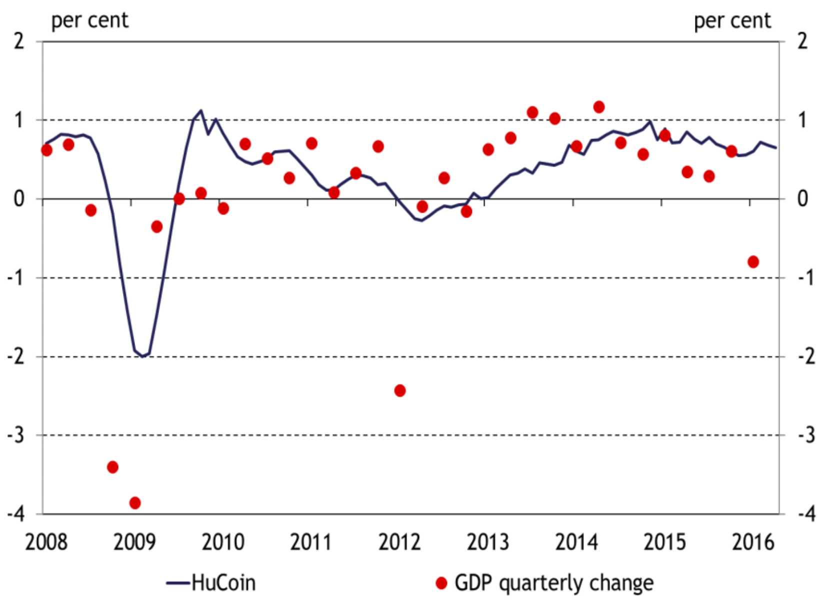


* Weighted average of monthly production indicators (industrial output, construction output and retail sales). The weights are derived from regression explaining GDP growth. Source: MNB calculation based on HCSO data.

Household consumption continued to recover in the first quarter, supported by a dynamically increasing real wage bill resulting from improving labour market trends, high wage outflows and low inflation. There was a considerable increase in household demand for durables and services. Whole-economy investments slowed in the first quarter, primarily due to the fall in government investments financed from EU funds at the beginning of the year. In a sectoral breakdown, government and quasi-fiscal entities, closely aligned with developments in EU funding, experienced a fall in investment activity, while corporate and household investments remained subdued. In the first quarter, the contribution of net exports to growth was negative, which is attributable to several factors. The slowdown in export dynamics is associated with disruptions to car manufacturing at the beginning of the year. The pickup in imports is primarily explained by an increase in consumption demand as imports for investment and re-export decreased. Export increased to a lesser degree compared to the previous quarters, in line with the slowdown in goods exports, while imports were up in parallel with the dynamic growth in more import-intensive items of consumption demand.

Capturing Hungary's cyclical outlook over the medium term, the HuCoin indicator has recently shown a slight increase, suggesting that the more subdued growth seen in the first quarter may have been temporary and growth could recover looking forward (Chart 5).

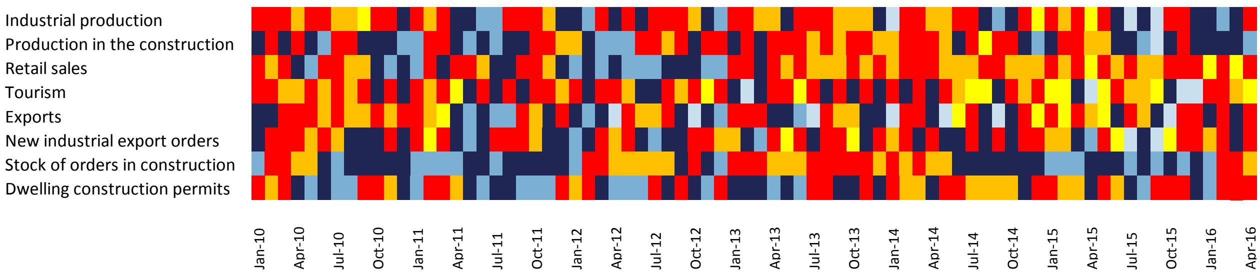
Chart 5: Evolution of the HuCoin indicator



Note: Due to the revisions to GDP data, the historic values of the HuCoin indicator may have also changed.

Source: HCSO, MNB calculations.

*Chart 6: Growth heat map**



* The growth heat map shows the three-month moving averages of the seasonally adjusted monthly growth rates of the most important monthly indicators of activity, using the following colour code: red = grows above the five-year average, at an accelerating rate; orange = grows above the average, at a slowing rate; yellow = grows below the average, at an accelerating rate; light blue = grows below the average, at a slowing rate; blue = falls at a slowing rate; dark blue = falls at an accelerating rate. Source: MNB calculations based on HCSO data.

In April 2016 industrial output was up 5.3 per cent year-on-year and 5.4 per cent compared to the previous month on a seasonally adjusted basis. In the first quarter, industrial output was subdued due to transitory effects; however, in April a significant correction was seen as output increased in most sectors, with a significant increase in car manufacturing, which carries the greatest weight. **The forward-looking indicators reflect an essentially favourable picture for the short-term outlook of the domestic industry.** Capturing the underlying cyclical processes of the euro area, the EuroCoin indicator recorded lower readings over the past four months, while in April Hungarian export orders increased year-on-year. However, there may be additional risk from the performance of the German industry significantly falling short of expectations, as signalled by the Ifo indicator. The indicator remains at levels around zero.

In line with the correction in industry, the beginning of the second quarter also saw a favourable turn in foreign trade. Based on preliminary data, expressed in euro terms, in April 2016 the value of exports increased by 5.1 per cent and that of imports fell by 1.9 per cent year-on-year. The balance of trade surplus was up EUR 527 million from last April.

In March 2016 the terms of trade continued to improve, with low energy prices remaining the largest contributor. Based on detailed data, relative to the preceding periods in the first quarter the annual growth rate slowed significantly in the product group carrying the greatest weight, machinery and transport equipment, in line with the deceleration in car manufacturing output.

In April 2016 **the volume of construction output was down 29.8 per cent year-on-year**, while output increased by 2.0 per cent compared to the previous month. In April, the output volume of both main construction groups fell compared to the high base of the same period in the previous year. The construction of buildings was down 2.7 per cent, while as a result of the slow start-up of projects implemented using EU funds, the volume of other construction fell by 52.1 per cent. The volume of contracts picked up from its low; however, year-on-year it continues to decline due to the previous year's high base.

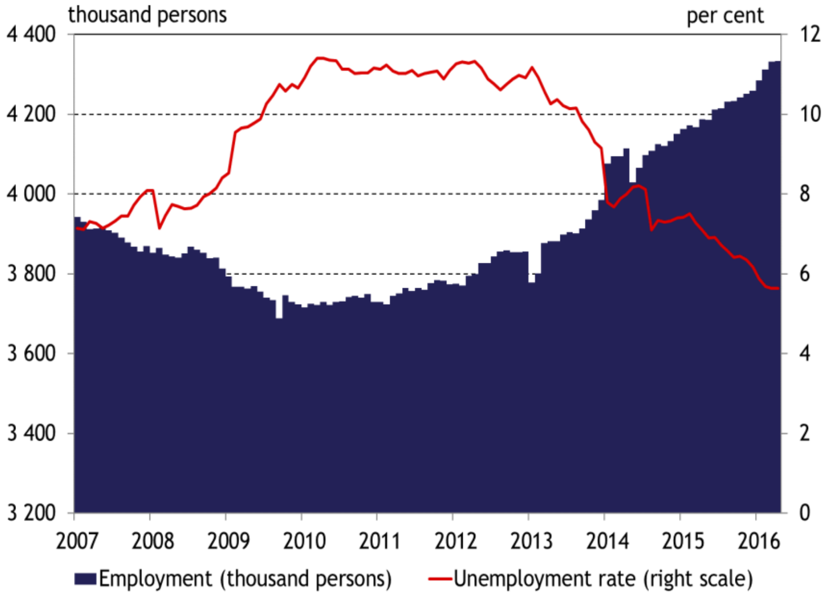
Consumption demand continued to recover at the beginning of the year, which may be explained by the improving labour market situation and by the increase in real wages as a result of low inflation, as well as by the upswing in retail sales volumes. **Based on preliminary data, in April the volume of retail sales was up 4.7 per cent year-on-year and 0.9 per cent compared to the previous month.** As regards the structure of sales, an increase in the volume of sales was registered for a wide range of products. The sales of non-food consumer durables contributed to the increase in the volume of retail sales to a greater extent than previously. This was accompanied by a continued growth in food and fuel sales.

1.2.2. Employment

According to Labour Force Survey data, **in April 2016 the number of employees in the national economy increased by 2.6 per cent year-on-year.** Labour force participation rate was similar to that measured in the previous month, with an unemployment rate of 5.7 per cent for April (Chart 7).

In the first quarter of 2016 the number of employees in the national economy increased further to a small degree. Relative to the previous quarter, the number of employees in the general government increased slightly despite a fall in the number of public workers in the first quarter. Following the dynamic growth seen in the previous year, the number of employees in the private sector grew at a more moderate rate. Within the private sector, the slight increase in the workforce in both manufacturing and the market services sector contributed to higher employment.

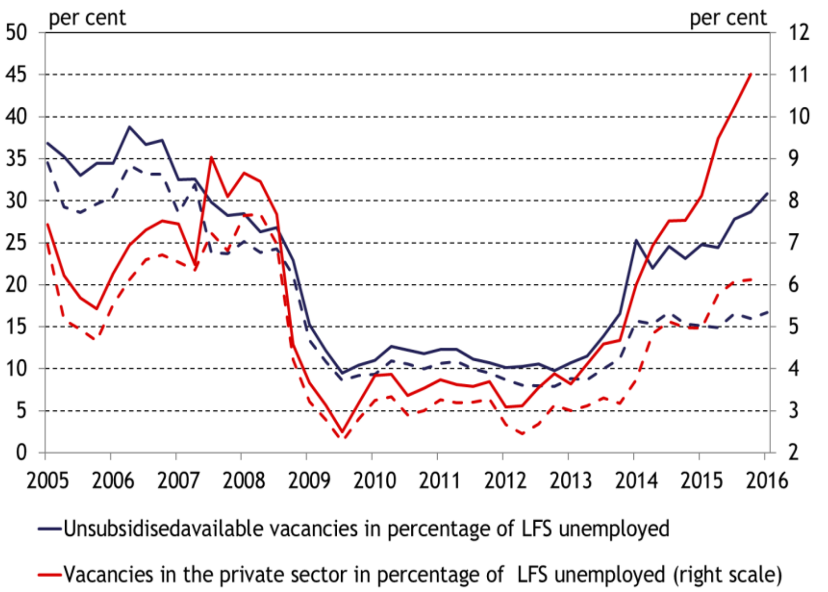
Chart 7: Number of persons employed and the unemployment rate



Source: HCSO.

In May 2016, there was no substantial change in the **number of newly announced non-subsidised jobs**, and the **end-of-month number of vacant non-subsidised jobs** reached a historical high in respect of the post-crisis period. The gradual tightening of the labour market, observed since 2013, has continued according to the tightness indicators calculated from the various statistics (Chart 8).

Chart 8: Indicators of labour market tightness



The dotted line marks labour market tightness indicators adjusted for public workers.

Source: National Employment Service, HCSO.

1.3. Inflation and wages

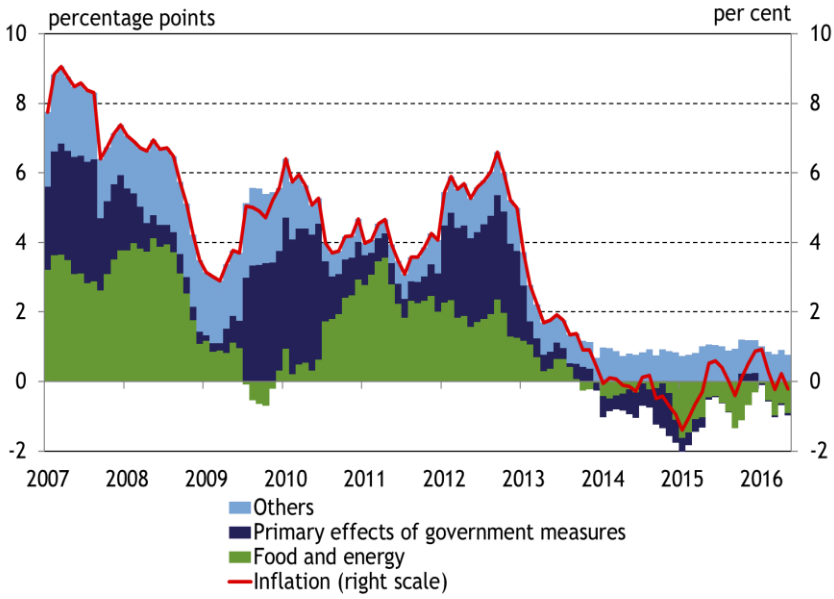
1.3.1. Wages

In the first quarter of 2016, the annual wage dynamics of the private sector accelerated relative to the previous year. In March 2016, according to the seasonally adjusted data, gross average wages in the private sector increased by 5.9 per cent year-on-year. The volume of bonuses paid in March was also higher than in the previous year. Within the private sector, in March the annual dynamics of gross average wages in the market services sector outperformed that of manufacturing.

1.3.2. Inflation developments

In May 2016, inflation was -0.2 per cent, while core inflation was 1.3 per cent and core inflation excluding indirect taxes stood at 1.1 per cent (Chart 9). Inflation was reduced primarily as a result of a fall in the price index of unprocessed food.

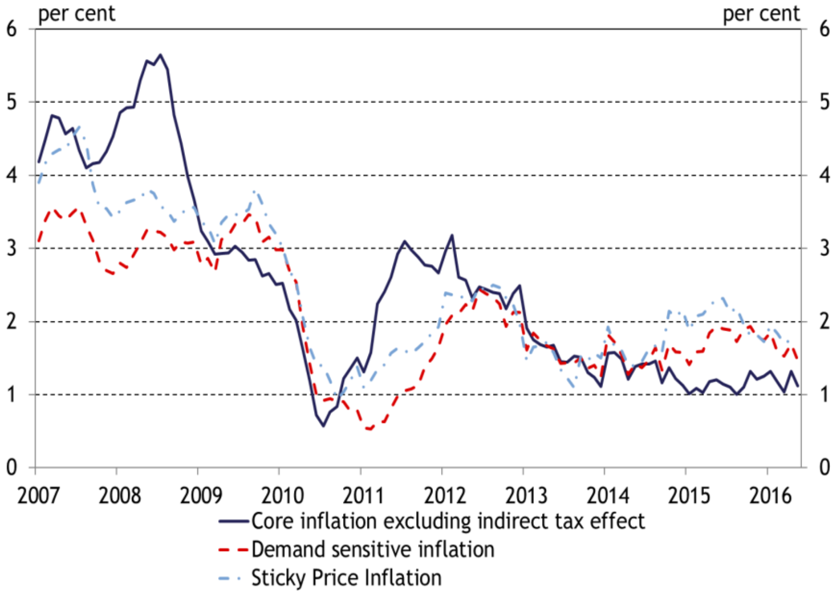
Chart 9: Decomposition of the consumer price index



Source: MNB calculation based on HCSO data

Underlying inflation indicators continue to point to a moderate inflation environment, which may be attributable to the low level of imported inflation, low commodity prices and the cyclical position of the economy (Chart 10). In April 2016, agricultural producer prices rose by 0.4 per cent in annual terms, while the domestic sales prices of the consumer goods sectors remained unchanged.

Chart 10: Measures of underlying inflation



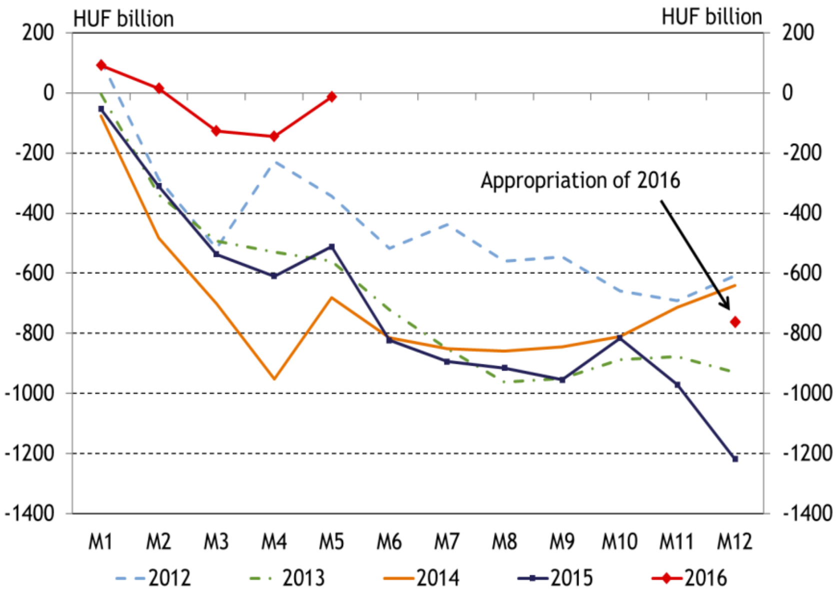
Source: MNB calculation based on HCSO data.

Looking ahead, inflation may significantly fall short of the 3 per cent target and may approximate it only by the end of the forecast horizon. Inflation may be close to 0 per cent in the short run.

1.4. Fiscal developments

The surplus of the central subsystem of the general government stood at HUF 132 billion in May 2016, representing a favourable balance relative to the same period of the previous years (Chart 11), and exceeding last May's balance, also showing a surplus, by HUF 33 billion. On the revenue side, the balance is primarily improved by wage-related revenues and single payments related to corporate tax, while in the case of expenditures, the deviation from the previous year's value is explained by the higher expenditures of central budgetary institutions and a reduction in spending related to EU grant programmes. In the first five months of the year, the cumulated cash deficit of the state budget was a mere HUF 13 billion, the lowest reading in recent years.

Chart 11: Intra-year cumulative cash balance of the state budget



Source: Budget Act 2016, Hungarian State Treasury.

In May 2016, the **revenues of the central subsystem from taxes and contributions** exceeded revenues for May 2015 by HUF 167 billion, close to one-half of which was attributable to the tax credit for growth. Additionally, revenues related to consumption and wages also grew dynamically year-on-year.

In May 2016, **expenditures in the central subsystem** exceeded those for May 2015 by HUF 144 billion, falling short of our forecast by only HUF 6 billion. Compared to data for last May, the increase in expenditures is explained by the net expenditures specific to the central budgetary institutions and chapters, and an increase in expenditures on pensions, accompanied by a meaningful decrease in the net expenditures of budgetary institutions related to EU grants.

1.5. External balance developments

According to the April data release, the seasonally unadjusted external financing capacity amounted to EUR 788 million, comprising surpluses of EUR 738 million and EUR 50 million in the current and capital accounts, respectively.

Financing data indicate a financing capacity of close to EUR 830 million in April, i.e. processes on the financing side also show an outflow of funds, affecting both debt and non-debt liabilities. The net amount of working capital outflow amounting to EUR 380 million is explained primarily by the dividend payments of foreign corporates commonly made in the season.

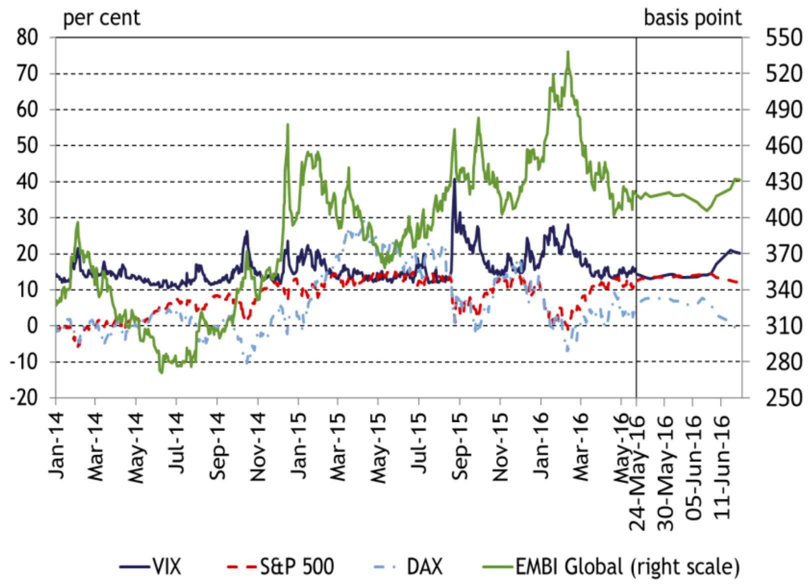
Simultaneously, net external debt fell by over EUR 450 million, which was attributable to the government and corporations. The net external debt of the general government was reduced primarily due to the effect of FX swaps expiring under FGS Pillar 3 increasing foreign exchange reserves. In April, the gross external debt of the general government was reduced by the repayment of the last instalment of the EU loan, without any effect on net debt. In April, the net external debt of banks showed a slight increase, contrasted by a decrease in that of corporates. The latter is attributable to the increase in assets placed abroad.

2. FINANCIAL MARKETS

2.1. International money markets

In most of the period since the latest interest rate decision, market sentiment was favourable, followed by a significant deterioration in risk appetite due to concerns over the UK referendum (Chart 12). Towards the end of the period, risk aversion intensified, largely driven by concerns over Brexit, as from early June onwards, in contrast with previous results, a growing number of opinion polls indicated the potential majority of UK voters opting for leave. **The US rate hike expectations heightened in May and dropped again in June to a great extent, due to the labour market data falling significantly short of expectations.** As expected, the ECB left its monetary policy unchanged, and market players also did not anticipate any changes in the Bank of Japan's interest rate-setting meeting in mid-June.

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



Source: Bloomberg.

Stock price indices appreciated in the first half of the period; however, the shift in risk perception was accompanied by a sharp fall in stock markets. As a result, since the previous interest rate decision, US stock market indices depreciated slightly overall, while, European stock markets, affected much stronger by concerns over Brexit, were down by 3 to 4.5 per cent. In emerging equity markets, the MSCI composite index appreciated 2 per cent overall despite the fall at the end of the period, possibly linked to decreasing US rate hike expectations.

In the first part of the period, risk indices fluctuated at relatively low levels, appreciating only towards the end of the period as risk aversion intensified. In line with increasing stock market indices, the VIX index moved along a low narrow trend up to middle of the period, showing a sharp increase towards the end of the period, and closing 6 percentage points above its opening level. The emerging bond market EMBI Global premium dropped by 15 basis points in the first part of the period, ultimately appreciating to 10 basis points above its opening level for the period.

By the end of the period, the decrease in risk appetite brought about a meaningful decline in the yields of long-term bonds of the developed markets, which are regarded as safe-haven assets. 10-year EUR, USD and GBP yields were down by 20 to 30 basis points, marking a low in decades in the case of UK yields and a reaching a level below zero in the case of the EUR yield, while the JPY yield dipped further into negative territory to -0.185 per cent.

The **price of oil** continued to rise in the first half of the period to reach USD 50 to 51 on the back of news of falling US production and unexpected decrease in output in other oil producing countries, and expectations of a rising trend of oil prices were not substantially influenced either by the meeting of OPEC countries in Vienna at the beginning of June. However, the end of the period also saw a fall in the oil market, due partly to unfavourable risk appetite and partly to the increase in the number of US oil wells following a continuously declining trend.

Of the main currencies, during the period the GBP depreciated, while the JPY and the CHF appreciated as risk aversion intensified. The rising trend of the USD against the EUR as seen in May was severely broken by the US labour market data published in early June, but later the US currency largely appreciated. The GBP depreciated against the EUR and the USD by 2 to 3 per cent due to the uncertainty over the outcome of the UK referendum, while the JPY and the CHF appreciated against the main currencies in the second half of the period.

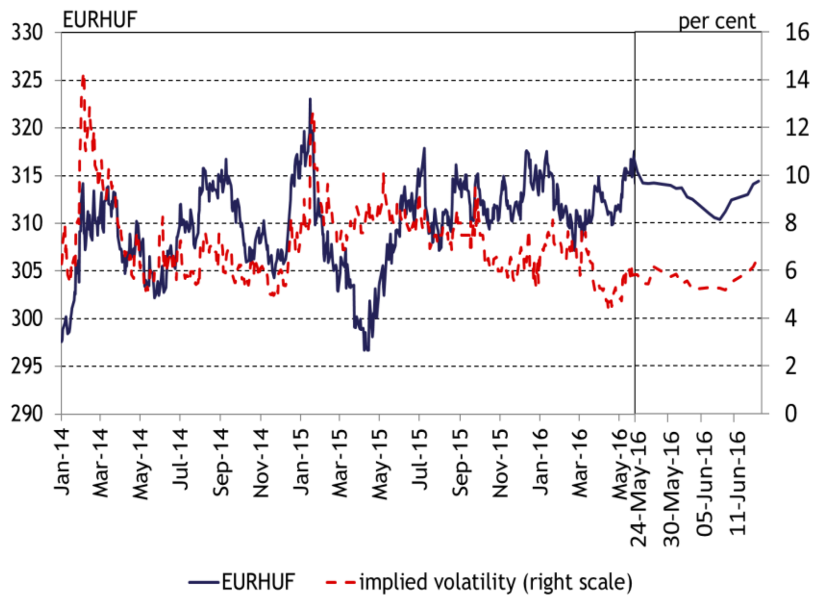
There was a turn in market expectations for the Fed's next rate hike, and the prospect of a possible rate hike in the summer diminished by the end of the period. Driven by the May communication of the FOMC and the minutes of April's interest rate-setting meeting published in May, over the month the market was pricing a US rate hike in the summer with increasing probability. However, the latest labour market figures released in early June, falling short of even the most pessimistic expectations, showed a mere 38,000 new jobs in the private sectors against the 160,000 expected, which resulted in a shift to a later date in market expectations for a rate hike. On the back of global risk aversion intensifying by mid-June, not only were expectations for a summer rate hike priced out, the cumulated probability of a rate hike in December also fell to about 40 per cent. The June interest rate decision and the subsequent communication suggest an increase in the number of members expecting only one rate hike this year.

In the euro area, no meaningful increase was seen in inflation processes; indeed, long-term expectations on inflation decreased further during the period. In its May meeting, the ECB held its rate levels, with only a slight upward adjustment to its 2016 outlook for growth and inflation, leaving its forecast for 2017 and 2018 essentially unchanged.

2.2. Developments in domestic money market indicators

In the past period the domestic asset prices were primarily driven by international factors. During the period, the EUR/HUF rate moved between the levels of 310 and 316. Following its 1.5 per cent appreciation at the beginning of the period, the HUF fell to around its opening level of 315 as international sentiment soured over Brexit, resulting in a 0.5 per cent overall appreciation of the Hungarian currency against the EUR since the latest interest rate decision (Chart 13). The forint and the Polish zloty moved along for most of the period, while the Romanian leu and the Czech koruna showed a minimal deviation. Hungarian data releases such as the inflation reading for May typically had a minor temporary impact on the exchange rate. The HUF and the CZK appreciated by 1 to 1.5 per cent against the USD, while the PLN and the RON appreciated by less than 1 per cent.

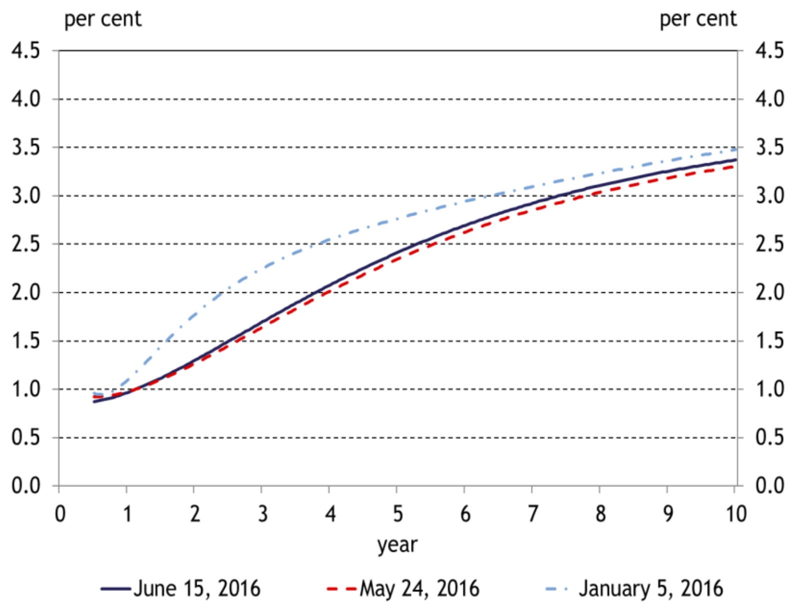
Chart 13: EUR/HUF exchange rate and the implied volatility of exchange rate expectations



Source: Bloomberg.

The yield curve of the government security market changed only slightly during the period and became somewhat steeper, with its short-term section moving slightly downwards, and its medium section and long tail moving slightly upwards (Chart 14). Short-term benchmark yields in the government securities market dropped by 3 to 5 basis points. The medium section of the yield curve increased by 3 to 4 basis points and longer-term yields above 7 years by 5 to 7 basis points.

Chart 14: Shifts in the spot government bond yield curve



Source: MNB, Reuters.

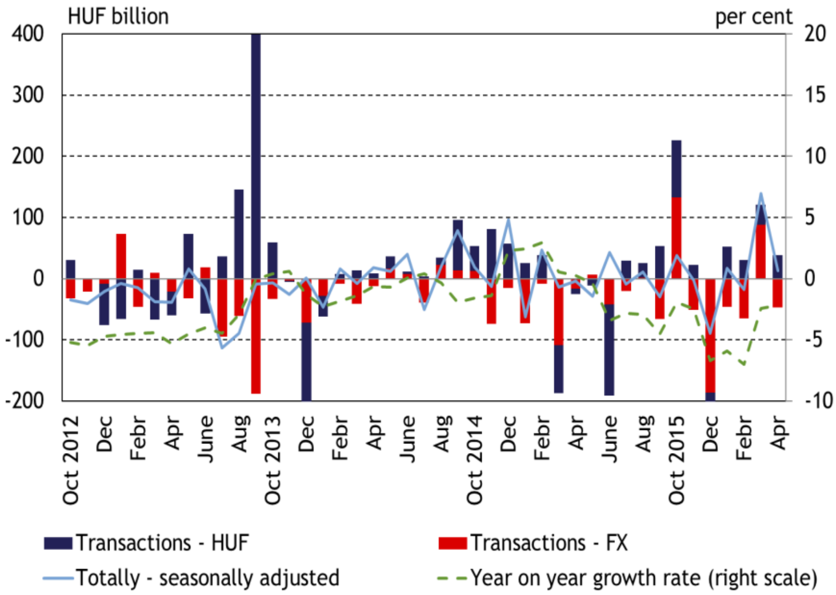
Demand at the bond auctions of the period was mostly healthy, enabling the Government Debt Management Agency to issue government bonds in excess of the quantity announced in almost every case. Sales of 3-month treasury bills were also strong, attracting demand 1.5 to 3 times the amounts issued, causing average yields to fall at the auctions. Demand for long-term fixed-rate government securities was also strong, with an outstanding 7-time oversubscription at the auction of June 9 for the 10-year bond. Bond yields at auction dropped by 5 to 7 basis points overall.

Foreign holdings of government securities increased since the previous interest rate decision, with their portfolio growing by over HUF 85 billion from HUF 3,582 billion to HUF 3,668 billion. In turn, the increase was preceded in the first half of the period by a major portfolio decrease, as part of which non-residents reduced their exposures by approximately HUF 100 billion. By the second half of the period, this reduction was corrected, and the share of foreign holdings within the portfolio of HUF government securities recovered to exceed 26.5 per cent. As international sentiment soured by the end of the period, the Hungarian 5-year CDS premium rose to 161 basis points in line with regional developments, where in the first half of the period premiums decreased, followed by an increase as market sentiment deteriorated.

3. TRENDS IN LENDING

In April, as a result of transactions, the **outstanding loans of credit institutions to the corporate sector** declined by a total of HUF 9 billion, equivalent to an increase of HUF 13 billion on a seasonally adjusted basis (Chart 15). In terms of denominations, forint loans increased by HUF 38 billion, while foreign currency loans fell by HUF 47 billion over the period. The annual rate of the decrease in the volume of lending slowed to 2.2 per cent from 2.4 per cent in March.

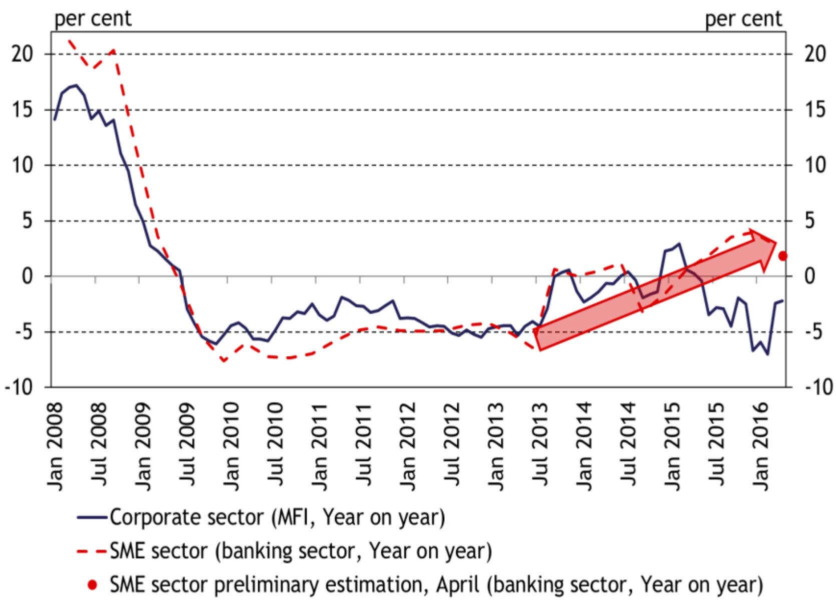
Chart 15: Net borrowing by non-financial corporations



Source: MNB.

By contrast, estimate based on preliminary data suggested an annual increase of 1.9 per cent in **loans to the SME segment** in April (Chart 16). Loan agreements made under Pillar 3 of the Funding for Growth Scheme contributed to the increase in the outstanding forint and foreign currency loan portfolio by HUF 13 billion and approximately HUF 2 billion, respectively.

Chart 16: Growth rate of loans outstanding of the whole corporate sector and the SME sector

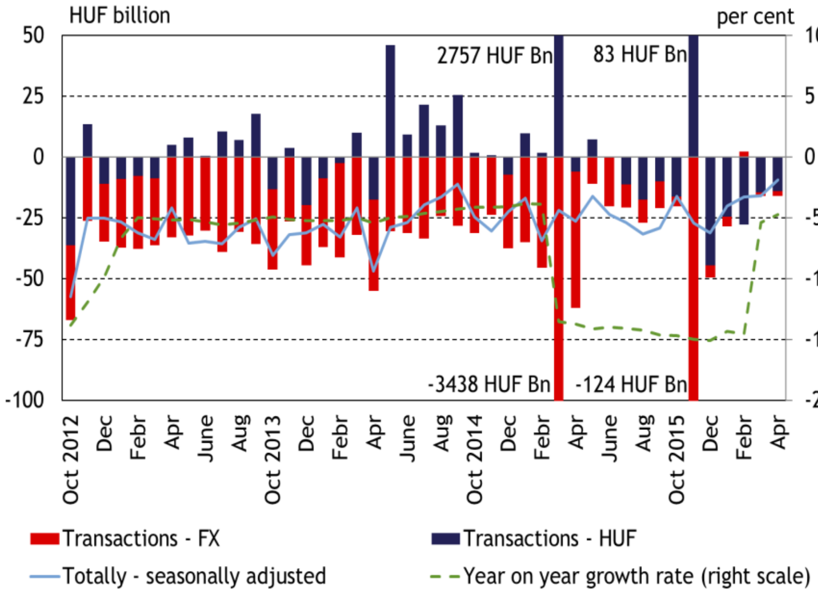


Source: MNB.

In April, in the case of **newly granted corporate loans**, the average annualised interest rate on small-value forint loans increased by 0.03 percentage points to 4.94 per cent from March, while the average interest rate on higher-value forint loans, net of money market transactions, increased by 1.25 percentage points to 3.53 per cent.

Outstanding loans of the household segment vis-à-vis the credit institutions sector declined by HUF 16 billion (Chart 17). Forint loans outstanding and total foreign currency loans fell by HUF 14 billion and HUF 2 billion, respectively. In April the annual decrease in loans outstanding amounted to 4.7 per cent.

Chart 17: Net borrowing by households



Source: MNB.

In April, interest rates on **new household loans** moved in different directions. The annual percentage rate of charge on forint housing loans dropped by 0.03 percentage point to 5.80 per cent, while that on general purpose forint loans rose by 0.64 percentage points to 8.10 per cent.