Macroeconomic and financial market developments

January 2015

Background material
to the abridged minutes of the
Monetary Council meeting
27 January 2015

Time of publication: 2 pm on 11 February 2015

The background material 'Macroeconomic and financial market developments' is based on information available until 23 January 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://www.mnb.hu/Monetaris_politika/donteshozatal/mnbhu_mt_jegyzokonyv

1. MACROECONOMIC DEVELOPMENTS

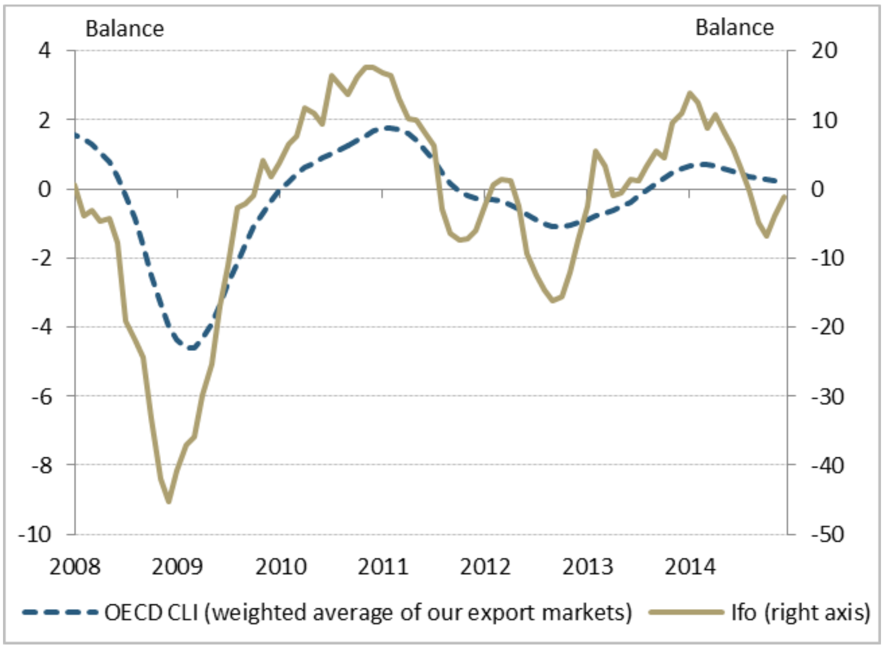
1.1. Global macroeconomic environment

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

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

The euro-area economy registered a quarter-on-quarter growth rate of 0.2 per cent in the third quarter of 2014. The monthly production data received show a slowdown in the economic activity of the region. Simultaneously, the forward-looking indicators of economic activity imply moderately improving performance. The slowdown in economic activity is partly the result of the tense geopolitical situation: growing insecurity and the expanding bilateral economic sanctions could cause a slowdown in economic activity. Accordingly, third-quarter growth slowed as foreshadowed by the deterioration in indicators of economic activity and production data. At the same time, from moderate levels, expectations for German economic growth (Ifo) improved further in December (Chart 1); thus, looking ahead, the slow improvement in economic activity may continue.

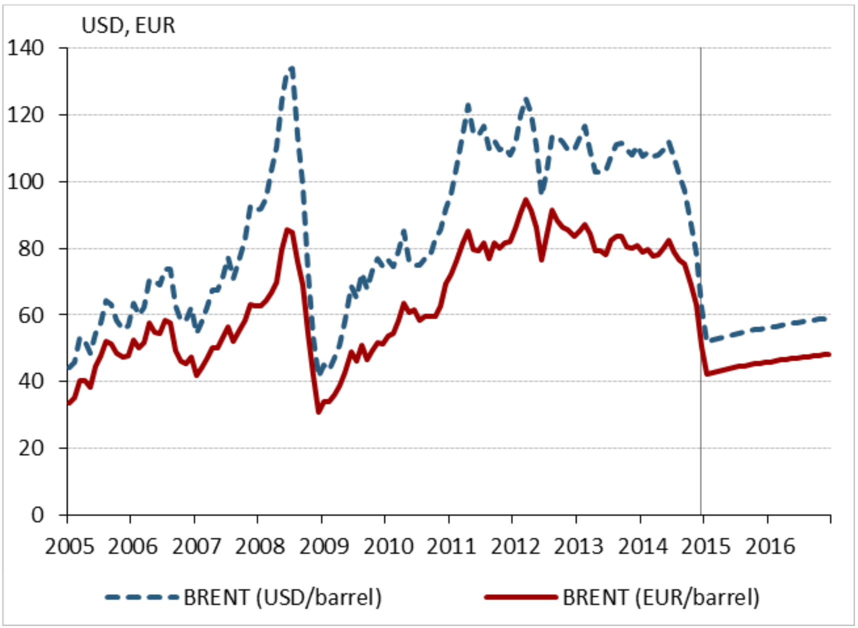
Chart 1: Indicators of activity in Hungary's export markets



The performance of Central and Eastern Europe was favourable in the third quarter but, according to monthly indicators, industrial output has slowed in the region in recent months. The escalation of the Russia-Ukraine conflict and the slowdown in Europe have had only a limited impact on growth in the CEE region so far, but looking ahead, the slowdown in the euro area may lead to a weakening in growth in the region as well. Based on the average of recent months, the industrial output of Germany, Hungary's main trade partner, stagnated overall.

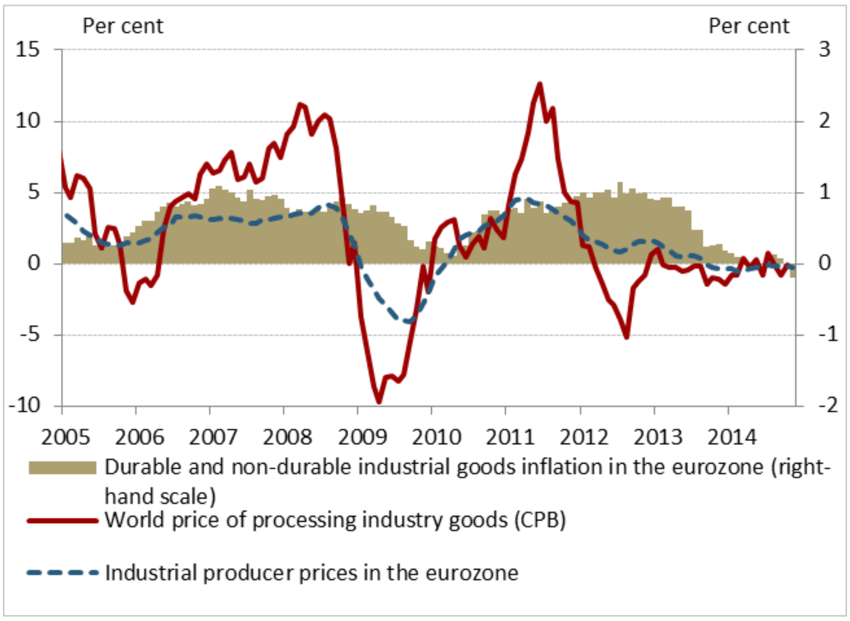
Inflationary pressures from the world market continued to weaken. Declining global commodity prices combined with slow global growth have reduced inflation. As a result, inflation rates remain below target in the world's major economies (annual inflation moved into the negative range in the euro area, standing at –0.2 per cent in December). Global oil prices continued to decrease in the first half of January, dropping below USD 50 by the middle of the month. Movements in the price of oil reflect weak demand mainly on account of slow growth in the larger oil importing economies, in addition to growing supply boosted by an increase in oil production by Saudi Arabia and the pick-up in shale oil extraction in the US (Chart 2).

Chart 2: World market price of Brent crude oil



Further downward pressure was exerted on oil prices by the fact that, led by Saudi Arabia, oil exporting countries comprising the OPEC reinforced their commitment to maintaining their production quota at high levels. In addition, the government of the United States also announced an increase in their crude oil export quota. The dynamics of the world market prices of industrial commodities and unprocessed food remained moderate. The world market prices of manufactured goods continued to be low (Chart 3).

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



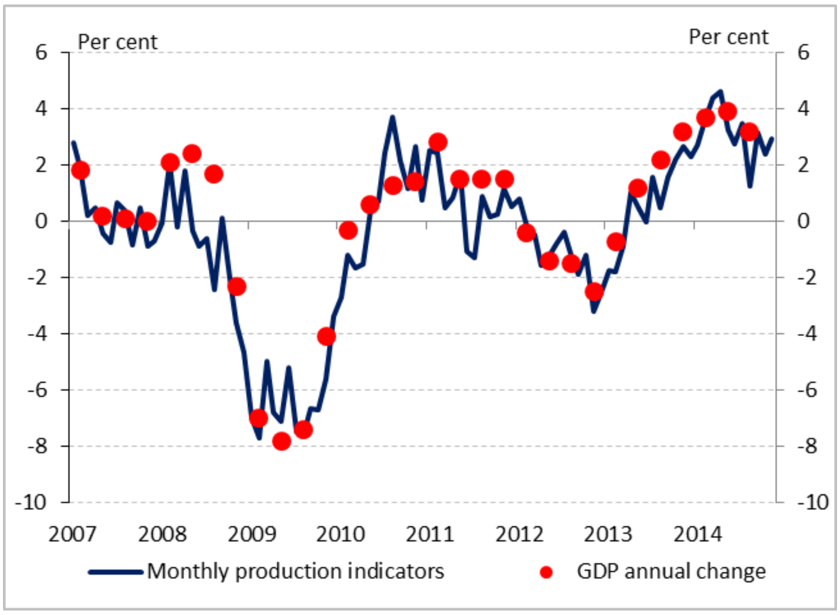
1.2. Domestic real economic developments

1.2.1. Economic growth

The economy continued to grow in the third quarter of 2014. Hungary's GDP expanded by 3.2 per cent year-on-year, with a 0.5 per cent growth recorded relative to the previous quarter.

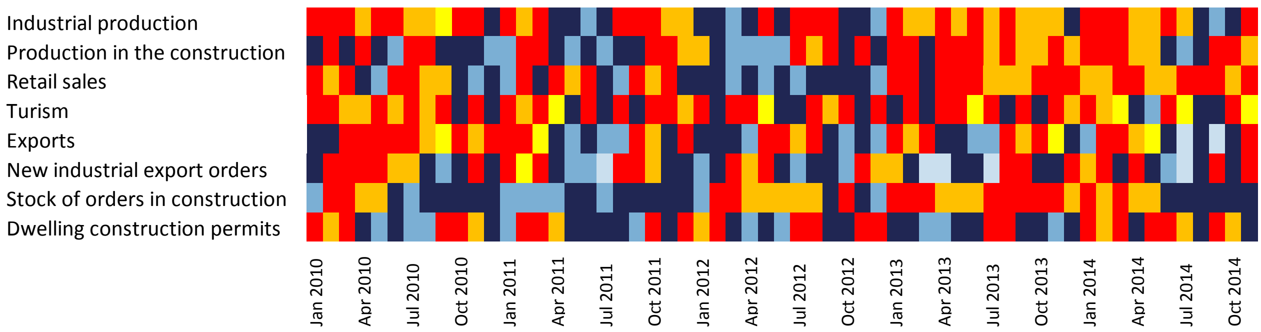
Growth slightly slowed in the third quarter (Chart 4). Industry and the construction industry contributed to GDP growth positively, although to a lesser extent than in the first half of the year, while the contribution of agriculture increased. In parallel with the recovery of internal demand, value added also expanded in a wide range of market services. Based on the monthly production indicators, growth is expected to decelerate further in the fourth quarter as evidenced by incoming data on industrial production.

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.

*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.

Industrial output increased in the third quarter by 6.6 per cent on an annual basis; however, it fell by 0.7 per cent quarter-on-quarter. **In November, industrial production rose by 5.8 per cent on a yearly basis and by 3.3 per cent compared to the previous month.** Compared to October, output increased in nine of the thirteen manufacturing subsectors. Industrial output has been volatile in recent months, owing, for the most part, to the fluctuating performance of the subsectors representing a significant weight (vehicle production, electronics and optics). The last time the time series exhibited similar volatility was in the summer of 2012. Weaker than expected European economic growth and Russia-Ukraine conflict, as well as the ensuing economic sanctions may have adversely affected the year-end industrial output. In addition, owing to its model changeover, production at the Suzuki plant may have been more subdued until early 2015. On the whole, forward-looking indicators point to a slight improvement. The ESI indicator for the Hungarian economy continued to improve.

In parallel with improving industrial performance, external trade expanded in November. As the effects of the one-off factors seen in recent months (the replenishing of natural gas reserves) faded, trade surplus increased again.

Construction output rose at 8.8 per cent (year-on-year) in November, but fell by 1.1 relative to the previous month. The performance of the sector can be primarily attributed to investment projects focused on infrastructure financed from EU sources, while private sector investment activity remained subdued. **The sharp decline in the number of new contracts observed in**

recent months for construction and the gradual decline in orders point to a slowdown in this sector's output growth.

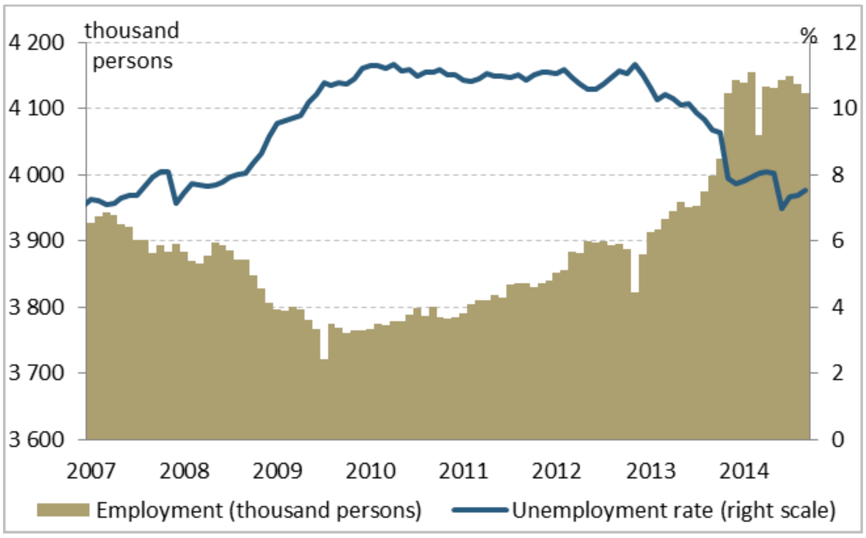
Consumption expanded further in the third quarter, bolstered by the improved labour market situation, rising real wages in the low inflation environment and the upswing in retail sales volumes. According to preliminary data, retail sales continued to rise in November and the growth rate reached 5.2 per cent year-on-year. The sharp decline in oil prices and hence, fuel prices, may boost the retail sales of non-fuel products looking ahead.

The baseline projection of the December Inflation Report foresees continued growth with a balanced structure. The economy is expected to have grown by 3.3 per cent in 2014. Hungarian economic growth may have decelerated slightly on a quarterly basis, in part reflecting one-off effects. The recovery in domestic demand, the intensive absorption of EU funds, loose monetary conditions and the improvement in labour market conditions all support growth, but the weakening global activity and the slowdown in the economic growth of Hungary's major export markets represent a downside risk looking ahead.

1.2.2. Employment

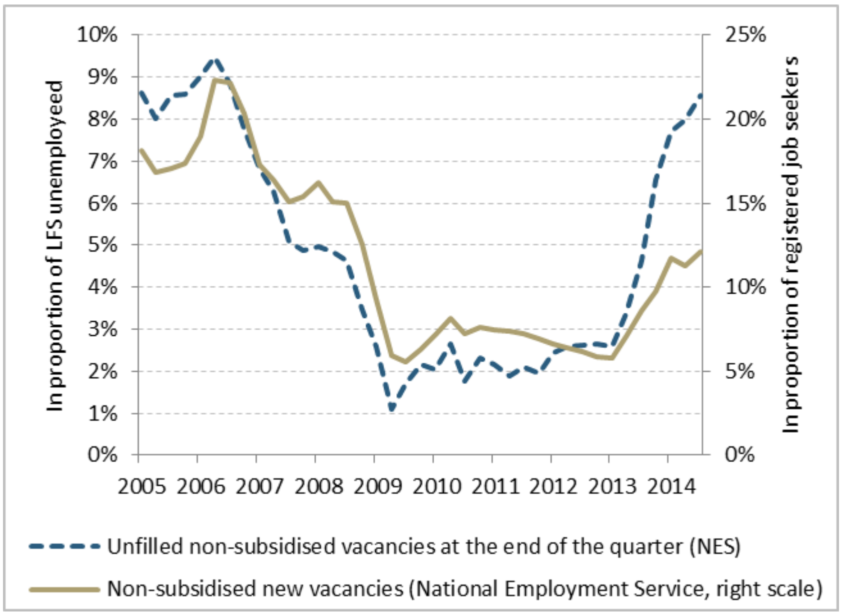
According to Labour Force Survey data, **the number of employees in the national economy rose by 4.8 per cent in the third quarter compared to the same period of the previous year.** Employment in the private sector continued to expand over the previous quarter. Public sector employment rose. November data — including public employment figures — indicate that unemployment in the national economy remained broadly unchanged relative to the previous period. **The unemployment rate increased compared to the previous months; seasonally adjusted unemployment stood at 7.5 per cent in November** (Chart 6).

Chart 6: Number of persons employed and the unemployment rate



In October, the number of newly announced non-subsidised jobs decreased compared to the previous month. The number of month-end unfilled vacancies has remained essentially unchanged in recent months. Coupled with the decline in registered unemployment this raises tightness indicators (Chart 7), which may point to rising mismatches in the labour market. Overall, **the labour market is tighter than recorded in recent years** (Chart 7). In October, the number of reported layoffs declined compared to the previous month, but it is still above the annual average.

Chart 7: Indicators of labour market tightness



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

1.3. Inflation and wages

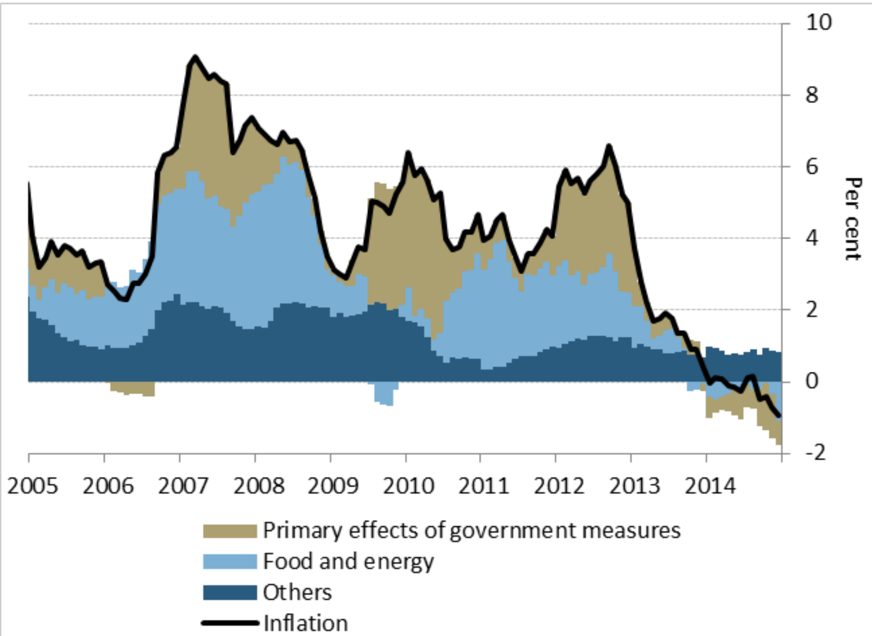
1.3.1. Wages

Gross private sector wages rose by 2 per cent in November compared to the same period of the previous year. The private sector wage index decelerated compared to previous months. Regular wages declined sharply month-on-month, while bonus payments increased in line with the levels usually seen in November. **The rate of the specific wage cost of the private sector, calculated by using the full-time equivalent staff, increased in the third quarter.**

1.3.2. Inflation developments

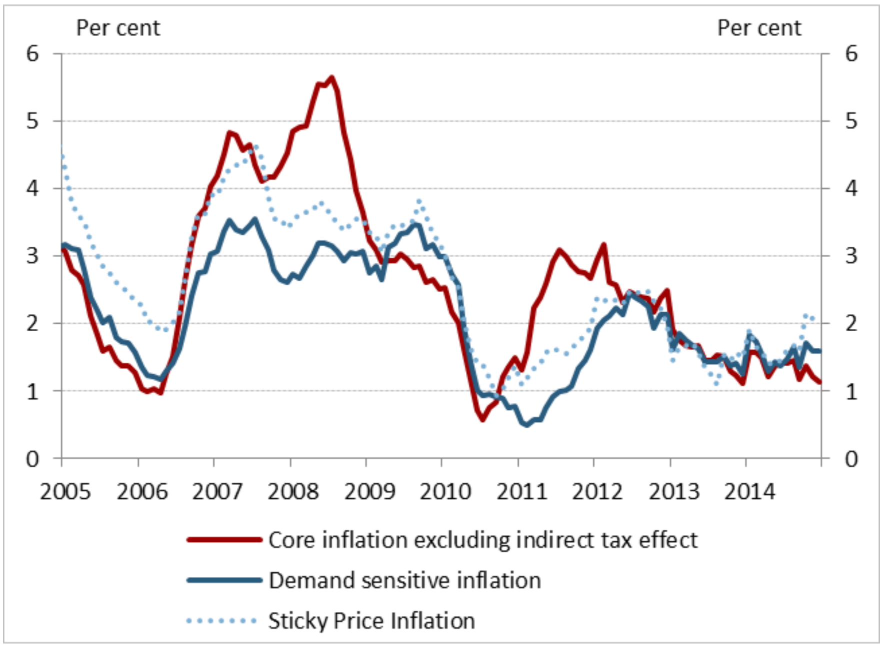
In December 2014, annual inflation was –0.9 per cent, while core inflation and core inflation excluding indirect taxes stood at 0.9 and 1.1 per cent, respectively (Chart 8). In the case of inflation, the decrease was primarily due to the decline in fuel prices. This was partly offset by the fact that the price cuts affecting administered prices at the end of 2013 dropped out of the basis. The decrease in the price index of processed food, alcohol and tobacco products contributed to the decline observed in core inflation.

Chart 8: Decomposition of the consumer price index



The substantial drop in oil prices, favourable demand developments, the adjustment of expectations and low imported inflation may all have contributed to the moderate underlying inflation recorded in recent months (Chart 9). In November 2014, agricultural producer prices fell by 8.1 per cent in annual terms, while the domestic sales prices of the consumer goods sectors rose by 0.8 per cent relative to the previous year. Fuel prices fell markedly compared to the previous month as a result of the decline in oil prices. Based on retail sales data, consumption demand may have increased gradually in recent months, in line with the year-on-year rise in real incomes. Despite this, the volume of retail sales remained well below pre-crisis levels. Consequently, domestic demand is likely to continue to exert a disinflationary impact, although this effect is gradually fading.

Chart 9: Measures of underlying inflation (per cent)



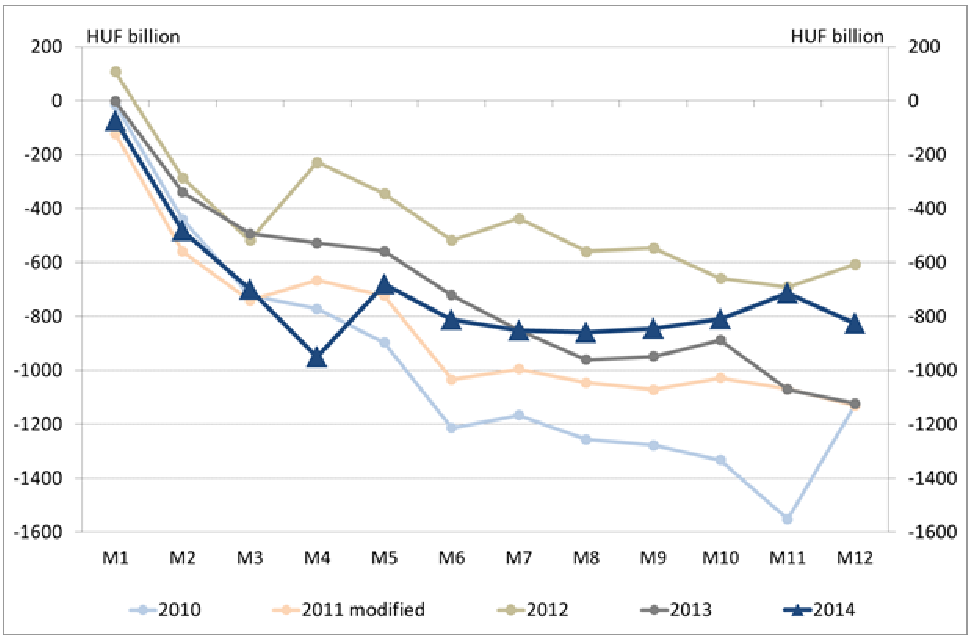
Inflation in Hungary is expected to remain below 0 per cent in the short term. Inflation in December was slightly below the expectations of the December Inflation Report, which can be attributed to lower-than-expected food prices. Inflation is likely to produce negative figures in the coming months, reflecting the decline in oil prices expressed in forint in recent weeks.

1.4. Fiscal developments

The deficit of the central subsystem of the general government stood at HUF 112 billion in December and the annual deficit was HUF 826 billion. Cash-flow deficit for 2014 was equal to 72 per cent of the amended cash-flow target deficit envisaged in the Budget Act, and proved to be favourable even in comparison to the values recorded in recent years (Chart 10). Deficit was HUF 103 billion lower in 2014 than the value recorded for 2013, largely reflecting the positive effect of favourable macroeconomic developments on revenue items related to consumption and wages.

Moreover, due to the reduced yield environment and higher interest revenues, net interest expenditures declined markedly compared to 2013.

Chart 10: Intra-year cumulated balance of the government budget



1.5. External balance

Hungary's seasonally unadjusted external surplus was nearly EUR 1 billion. The increase in the country's external surplus mainly reflected the rise in the balance of goods related to the output of the automobile industry, but improving terms of trade amid falling oil prices may also have contributed to the increase. The transfer surplus remained significant, mainly owing to EU transfers, while the income balance deficit remained low.

Based on financial account data, debt liabilities continued to fall, while net foreign direct investment increased significantly. In November, Hungary's financing capacity, calculated on the basis of the financial account, amounted to EUR 260 million. This resulted from an outflow of more than EUR 700 million in debt liabilities and a EUR 1.2 billion inflow of FDI liabilities. Due to the absorption of EU transfers, general government net external debt consolidated with the MNB declined, but the effect of the decline was mitigated by non-residents' purchases of government securities. Besides the consolidated general government, companies also reduced, while banks slightly increased their external liabilities.

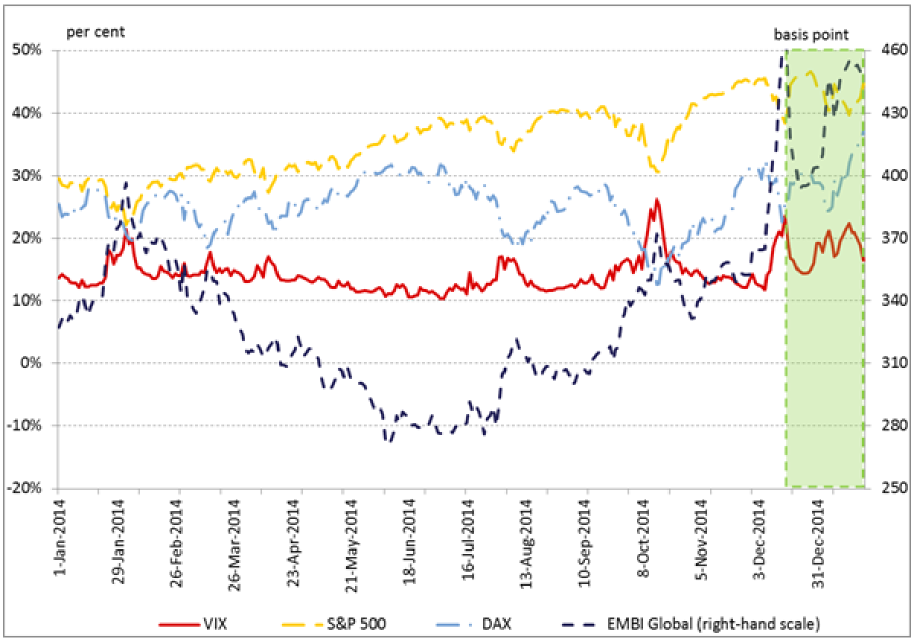
2. FINANCIAL MARKET DEVELOPMENTS

2.1. International financial markets

In the period since the last interest rate decision, risk appetite has been extremely volatile in money and capital markets. At the beginning of the period, the drastic depreciation of the Russian rouble and the ensuing market turbulence gave rise to a sharp rise in risk aversion before, following a temporary period of tranquillity, risk appetite deteriorated again in bond markets in the second part of the period. Meanwhile, the market sentiment in developed equity markets improved. Apart from these events, exchange rate changes triggered by the Swiss National Bank's decision to remove the exchange rate floor of 1.20 on the value of the euro versus the Swiss franc and the positive market effects of the ECB's bond purchase programme came into focus. In response to the events in Russia, the developed equity market VIX index rose to 23 per cent. This was followed by a temporary moderation before the VIX started to increase once again until the ECB's decision finally brought about a sharp decline in the index (Chart 11). However, the evolution of the developed market bond volatility MOVE index suggested that bond markets were surrounded by higher uncertainty than earlier. The emerging market EMBI Global index also exhibited significant swings: initially it rose to 477 points in mid-December — a level not seen since 2011 —, then, after a temporary decline, it rose sharply again to 450 basis points in the first half of January. On the whole, despite a transitional period of tranquillity, markets continue to be tense in the context of uncertainty regarding the monetary policy of developed central banks, the threat of the euro area's potential sinking into deflation, the decrease in oil prices and turbulences in emerging markets, although this was somewhat offset by the announcement of the ECB's QE.

Stock markets managed to increase noticeably during the period: US stock market indices rose by 4–5 per cent in response to the halt in the oil price decline, the optimistic tone of the FOMC Minutes and the announcement of the ECB's asset purchase programme, while developed European stock markets were able to improve by 8–9 per cent as the uncertainties around the Greek internal policy subsided and the ECB made its decision. The US and German ten-year yields fell by 10–20 basis points. The European periphery countries saw a 50 basis point decline in the yield of long-term maturities. The only exception was Greece, where the combined effect of heightened uncertainties surrounding the early parliamentary election and the ECB's announcement of asset purchases translated into a 10 basis point decline in yields.

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



The price of oil continued to fall during the period; it has halved in the span of six months since summer 2014. Brent and WTI crude oil prices continued to decline further in December and in the first half of January (by 15–18 per cent); the only slight positive adjustment took place at the end of the period. That notwithstanding, the price of oil is expected to remain close to its current low level throughout 2015.

Macroeconomic data received from the US were mixed overall. Standing at 5 per cent at the beginning of the period, the final 3rd quarterly GDP growth data not only exceeded expectations but also outperformed the preliminary data. The effect of this impressive figure was somewhat deteriorated by the significantly worse-than-expected value of retail trade statistics in December. In line with the global disinflationary trends, the latest data point to a significant decline in inflation in the United States as well. According to market analysts, the downward shift in inflation may prolong the date of the Fed’s first interest rate increase.

Data from the euro area were also mixed. Inflation drifted to a historical low, which heightened market expectations about the ECB’s monetary easing. The December inflation figure of the euro area was published, showing inflation at –0.2 per cent in December compared to 0.3 per cent in November. Dipping below consensus, the inflation data heightened market expectations about the January announcement of the ECB’s asset purchase programme. The loss in momentum of the euro area economy was not only apparent in the downturn in German manufacturing industry orders, but also in the final purchasing managers indices in November, which foreshadow extremely subdued GDP growth for the fourth quarter. The euro fell considerably, by 9–10 per cent, against the dollar in the period, but it also depreciated against the GBP and the JPY. The euro weakened against the Swiss franc by 18 per cent.

The event exerting the greatest impact in Europe was the ECB’s announcement. In view of the risks of deflation, market analysts expected the announcement of a government security purchase programme in the range of EUR 500–1,000 billion at the ECB’s rate-setting meeting in January. According to the announcement, the combined monthly security purchases of the ECB in the secondary market will amount to EUR 60 billion between March 2015 and September 2016. The programme encompasses the purchase of investment-grade euro area (excluding EU/IMF programme countries) bonds (mainly government securities) starting in March, and the previously announced and launched asset-backed securities purchase and covered bond purchase programmes. The purpose of the expanded programme is to fulfil the ECB’s price stability mandate by achieving euro area inflation rates that are consistent with the inflation target. Thus, slightly exceeding expectations, total purchases will amount to EUR 1,100 billion overall. The commitment to the ECB’s inflation mandate is reinforced by the fact that the programme is essentially uncapped; in other words, the asset purchases may be continued until the inflation outlook improves.

The euro fell by 2–2.5 per cent after the announcement. The previous rise in main stock indices gained new momentum, while ten-year euro area yields fell by 15–30 basis points, reaching, in most cases, unprecedented lows. Yields, risk spreads and exchange rates in the region also responded positively to the ECB’s steps: ten-year yields dropped by 5–15 basis points, currencies strengthened by around 1 per cent, while five-year CDS spreads declined by 5–8 per cent.

As the repeated rounds of the Greek presidential elections yielded no result in December, early parliamentary elections were announced for 25 January in Greece. Upon the announcement the Greek credit default swap jumped above 1,200 basis points, while bond yields rose given the substantial uncertainty about the outlook of Greece as public polls increasingly pointed to a likely victory of the anti-euro Syriza party. Fears about Greece’s potential exit (“Grexit”) from the euro area exacerbated in January, pushing ten-year Greek yields to 10 per cent and five-year CDS spreads to above 1,500 basis points. By mid-January, however, more moderate statements by the decision-makers of the likely winner alleviated the concerns somewhat, which were eased further by the ECB's announcement.

The decision of the Swiss National Bank to abandon the exchange rate cap between the euro and the Swiss franc in mid-January caused extreme market turmoil. At its rate-setting meeting, the central bank reduced the key policy rate to –0.75 per cent from –0.25 per cent, and unexpectedly eliminated the exchange rate floor of 1.20 on the value of the euro versus the Swiss franc maintained for the previous 3 years. Within minutes of the announcement, the exchange rate of the Swiss franc against the euro soared by nearly 25 per cent and it resided at levels close to parity even at the end of the period. Regional exchange rates against the Swiss franc plunged by around 30–40 per cent immediately after the announcement, and after the initial market panic has settled, they uniformly showed a devaluation of about 20 per cent. At the same time, regional exchange rates against the euro behaved differently: while the HUF/EUR and PLN/EUR cross rates responded to the announcement by intensified volatility, the RON/EUR and CZK/EUR exchange rates showed minor shifts only.

After an extreme slide in mid-December, the **rouble** managed to strengthen somewhat by the middle of the period as a result of central bank intervention; in January, however, the continuing fall in oil prices pushed down its exchange rate against the dollar to the 66–67 levels observed at the beginning of the period. Of the credit rating agencies, S&P placed Russia on CreditWatch negative as early as December, while Fitch downgraded Russia's sovereign credit rating to "BBB" in January with a negative outlook, foreshadowing further downgrading down the road. Moody's, in turn, worsened the country's credit rating to Baa3, the bottom of the investment grade category, and put Russian government debt on watch.

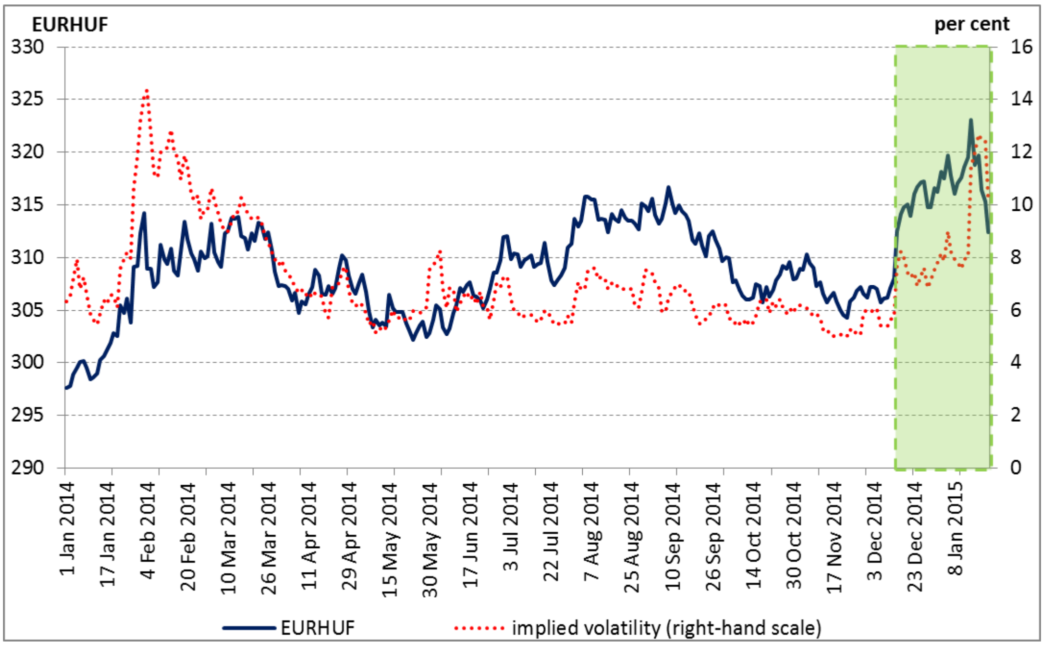
Regional currencies initially depreciated in the context of lower-than-expected inflation data, but this was partly alleviated by the ECB's decision on expanding its asset purchase programme. In the review period, the exchange rates of regional currencies weakened by 0–1 per cent against the euro and by 9–10 per cent against the dollar. The release of weaker-than-expected inflation data in January heightened regional deflationary concerns, with an increasing number of analysts expecting regional central banks to perform further easing in the course of 2015 through interest rate cuts or other monetary measures.

2.2. Developments in domestic money market indicators

Domestic financial market developments have been influenced both by international and country-specific factors since the Monetary Council's latest interest rate decision. Of domestic events, the weaker-than-expected inflation outcome in December had the most significant market impact; the HUF/EUR exchange rate depreciated by nearly half a per cent following the data release. In a positive development, Hungarian retail sale and preliminary industrial production figures proved to be better than anticipated, and the budget deficit for 2014 was also lower than expected.

The forint exchange rate exhibited some fluctuations during the month. Compared to the levels recorded in November, the HUF/EUR exchange rate weakened significantly overall, moving between 310 and 323.3 during the period before strengthening back to the 311–312 level after the ECB's announcement (Chart 12). As a result of the Swiss National Bank's announcement, the EUR exchange rate broke through its intraday historic trough of 324 before it stabilised again. Depreciation against the dollar was even more drastic (9–10 per cent) during the period. On the day of the Swiss central bank's announcement the HUF/CHF exchange rate fell steeply to 371 from 266, and subsequently fluctuated around a level of 317 at the end of the period, which translates into an overall depreciation of 20–22 per cent.

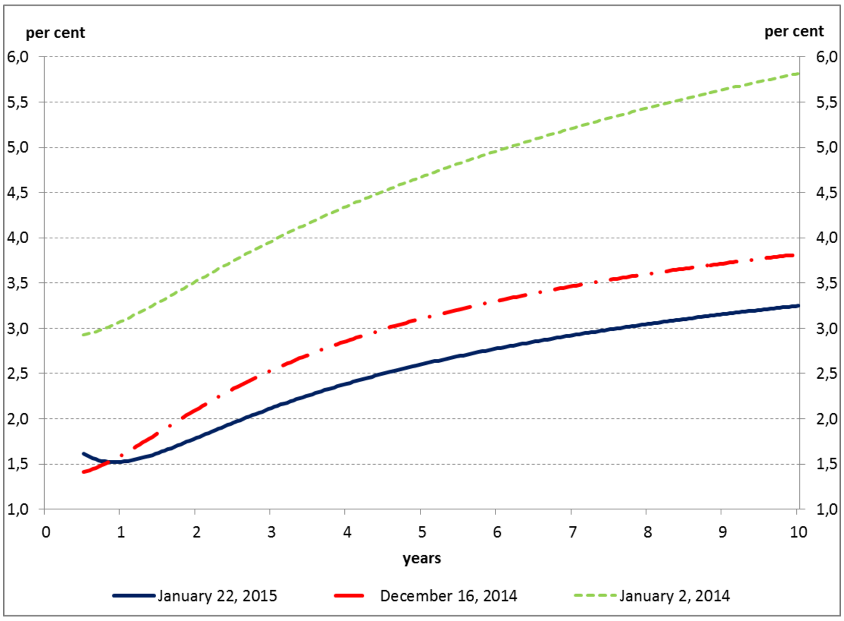
Chart 12: EUR/HUF exchange rate and its implied volatility



As a result of the Russian turbulence, the Hungarian five-year CDS spread soared to 208 basis points before moderating to levels between 170 and 180 basis points. Subsequently it resided in this range for the most part of the period until it declined slightly upon the ECB's announcement. This suggests that Hungary's risk assessment changed mainly as a result of international factors.

The steepness of the Hungarian government securities yield curve has declined considerably since the previous interest rate decision (Chart 13). Yields at the short end of the curve rose by 10 basis points on average. As regards long-term maturities, yields decreased by 50–60 basis points, while the ten-year yield dropped to 3.1 per cent. In the region overall, long-term yields decreased to a similar extent, by 45–75 basis points.

Chart 13: Shifts in the spot government bond yield curve

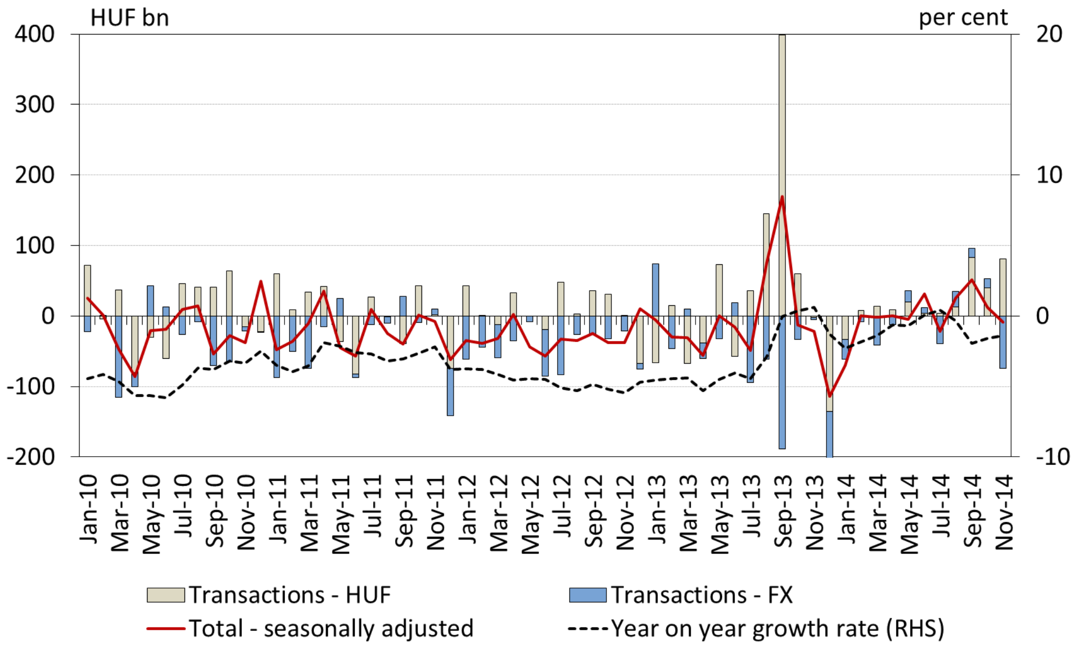


There was mixed demand at the government securities auctions during the period. After a reduction in December, the Debt Manager increased auction volumes of three-month securities again from the beginning of the year, and as a result of the triple coverage, it raised issuance to HUF 80 and HUF 90 billion for the auctions held in January 2015. Auction yields on three-month discount Treasury bills rose by 50 basis points to 1.84 per cent before falling by 10 basis points to 1.75 per cent in mid-January. Demand was subdued for the one-year discount Treasury bills both at the end-of-year and mid-January auctions — the latter being attributed to the announcement of the Swiss National Bank. Consequently, the Debt Manager cut the quantity offered in both cases. There was healthy demand and increased issuance at the auction of long-term securities, and yields have declined markedly since the previous interest rate decision.

3. TRENDS IN LENDING

In November, outstanding lending by banks to the corporate sector rose by HUF 7 billion in total. Seasonally adjusted, the value of transactions was HUF –8.5 billion (Chart 14). Looking at the currency breakdown, outstanding forint loans increased by HUF 81 billion, while foreign currency loans declined by HUF 74 billion. Loans disbursed under Pillar 1 of the Funding for Growth Scheme contributed around HUF 44 billion to the increase in forint loans in November. The transaction-based annual rate of contraction moderated to 1.39 per cent from the 1.58 per cent rate recorded in October. The gross amount of new corporate loans extended by the credit institution sector as a whole was HUF 147 billion in November. Of the new contracts, the volume of forint loans was HUF 119 billion, while that of the euro-denominated loans was HUF 26 billion. In November, contracts for HUF 57 billion were concluded in the framework of the FGS, which accounted for nearly 40 per cent of all new loans.

Chart 14: Net borrowing by non-financial corporations



Households were net loan repayers to the entire credit institution sector: the value of transactions was HUF –23 billion which, seasonally adjusted, translates into HUF –33.6 billion (Chart 15). The decline in the loan portfolio can still be attributed to the contraction in foreign currency loans, which amounted to HUF –23.8 billion during the review period. In the case of forint-denominated loans, the level of repayments roughly corresponded to that of disbursements; thus the transaction-based change in the portfolio was around HUF 0.8 billion in

November. At 4.1 per cent, the annual rate of decline in stocks remained largely unchanged relative to the previous month. The gross volume of new household loans extended by the credit institution sector amounted to HUF 47 billion in November. Housing and personal loans continued to recover. In these segments, the number of new contracts exceeded the value recorded in the same period of the previous year by 58 and 42 per cent, respectively.

Chart 15: Net borrowing by households