Macroeconomic and financial market developments

May 2015

Background material
to the abridged minutes of the
Monetary Council meeting
26 May 2015

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The background material 'Macroeconomic and financial market developments' is based on information available until 21 May 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

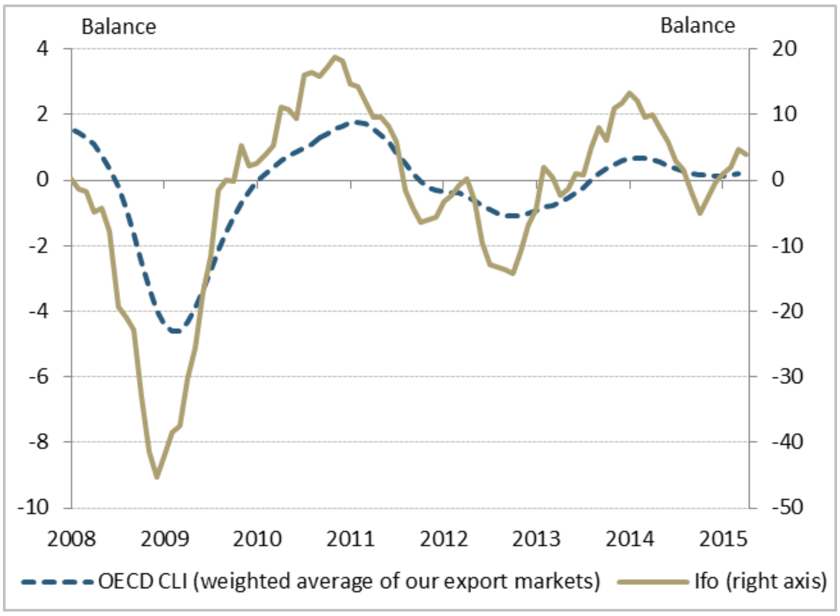
1.1. Global macroeconomic environment

GDP data in 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 continues to be subdued compared to pre-crisis levels. Persisting geopolitical tensions are acting as a brake on growth in developed countries through weaker demand and economic sanctions. The steep decline in oil prices observed earlier may boost growth in oil-importing economies, while slowing inflation. Inflationary pressure from the world market has remained weak in recent month as a result of the still 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 rate 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. Monthly production data 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 increasing uncertainty and bilateral economic sanctions. However, in addition to this, economic expansion continued at the moderate rate seen in the previous quarters. The economy of Germany, Hungary's most important export partner, grew moderately in the first quarter, while German domestic demand continues to expand; external market activity has been curbed by the Russia-Ukraine conflict and the decelerating Asian demand. Expectations for German economic growth (Ifo) continued to increase in the first months of 2015 (Chart 1) and the stock of industrial orders has increased moderately in recent months; thus, looking ahead, the slow improvement in economic activity may continue.

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

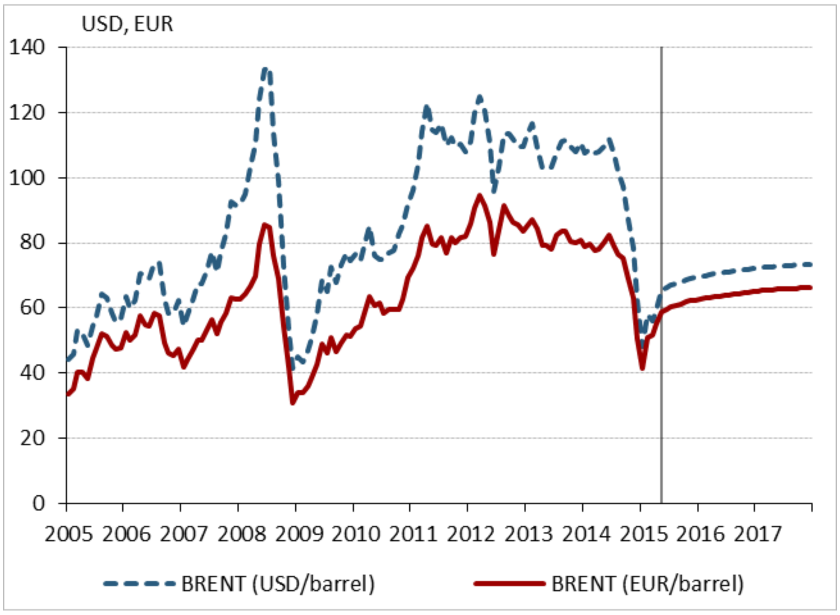


Sources: OECD, Ifo

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 repercussions 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 decline in growth of the Ukrainian and Russian economies may exert, both directly and indirectly, a negative impact on economic growth in the region.

Inflationary pressure from the world market remains weak. Still moderate commodity prices combined with slowly increasing world economy have reduced inflation. As a result, inflation rates remain below target in the world's major economies (euro area inflation stood at 0.0 per cent in April). In recent weeks the world market price of oil increased slightly and fluctuated at the level of USD 61-68. On the whole, however, oil prices remain subdued, which – in addition to the still high supply – may be a result of the moderate demand experienced due to the slowdown in growth of mainly the major importer countries (Chart 2).

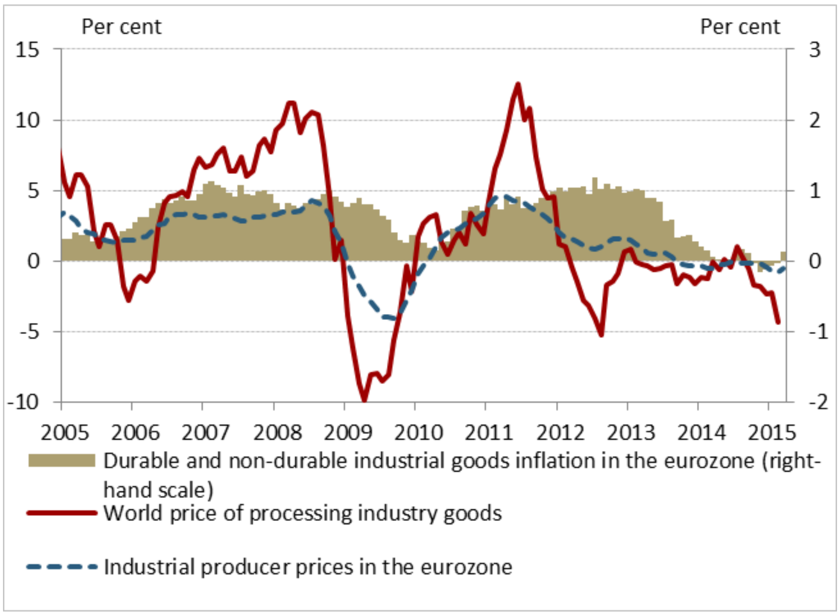
Chart 2: World market price of Brent crude oil



Source: Bloomberg

Movements in the world market prices of industrial commodities, unprocessed food and manufactured goods continued to be moderate (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

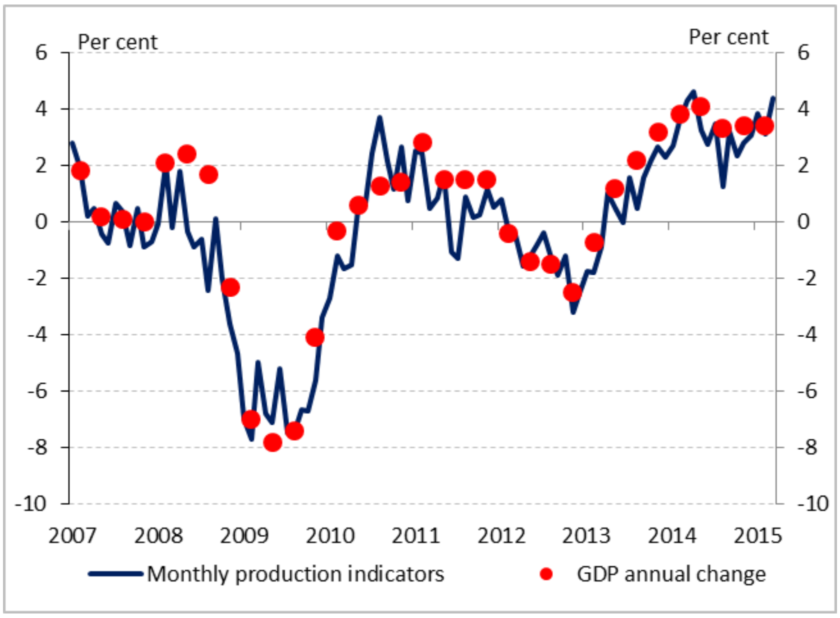
1.2. Domestic real economy developments

1.2.1. Economic growth

The Hungarian economy continued to grow in the first quarter of 2015. Hungary's GDP was up 3.4 per cent year-on-year, with a 0.6 per cent growth recorded relative to the previous quarter.

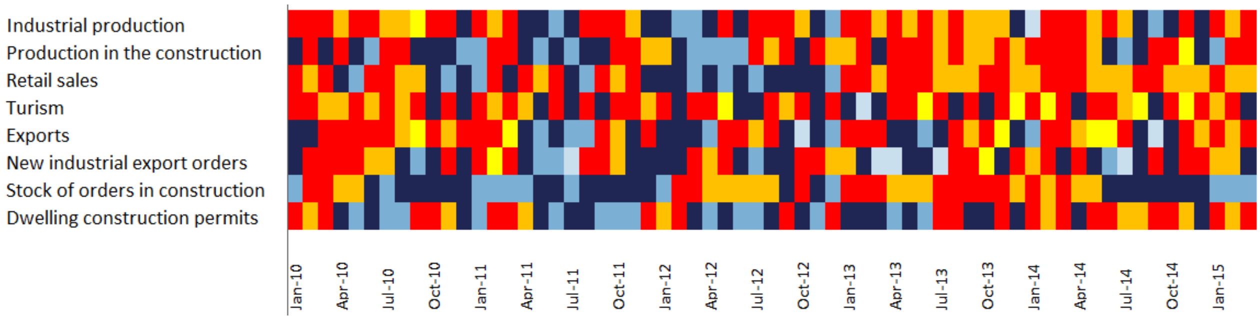
Economic growth may have been supported mainly by the positive performance of industry (Chart 4). Based on the monthly statistics the increase in the manufacturing sector's output was still linked primarily to the favourable performance of vehicle manufacturing and the related sub-sectors.

Chart 4: Monthly production indicators and GDP*



* Weighted average of monthly production indicators (industry, construction and retail trade). The weights are derived from regression explaining GDP growth. Sources: 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 March 2015, industrial output rose by 11.6 per cent year-on-year, and by 9 per cent excluding the working-day effect. Seasonally adjusted production level excluding the working-day effect was **up 2.6 per cent compared to the previous month.** In the first quarter of 2015 industrial output increased by **5.4 per cent quarter-on-quarter**. Production increased in most of the manufacturing subsectors. Forward-looking indicators point to improving prospects overall. The Eurocoin indicator, which shows the underlying trends of the euro area economic activity, and the value of the ESI indicator for the Hungarian economy both increased in April 2015, while the value of the Ifo index, which reflects the outlook for the German economy, was similar to that registered in the previous month.

Denominated in euro, in March the value of **exports and imports increased by 13 per cent and 9.8 per cent, respectively, year-on-year**. The trade surplus exceeded its value registered in March last year. In February the terms of trade declined compared to the previous month accompanied by increasing import prices and constant export prices.

In March 2015 construction output rose by 12.7 per cent year-on-year, while adjusted seasonally and for the working-day effect, **output increased by 6.3 per cent compared to the previous month.** In the first quarter of 2015 **production increased by 7.2 per cent compared to the fourth quarter of 2014.** The performance of the sector is expected to be subdued during 2015, which may be justified by the steady decline in the book of contracts and the high base of last year. Approaching the end of the 2007–2013 EU programming period, infrastructural projects financed from EU funds may gradually come to an end in the course of the year.

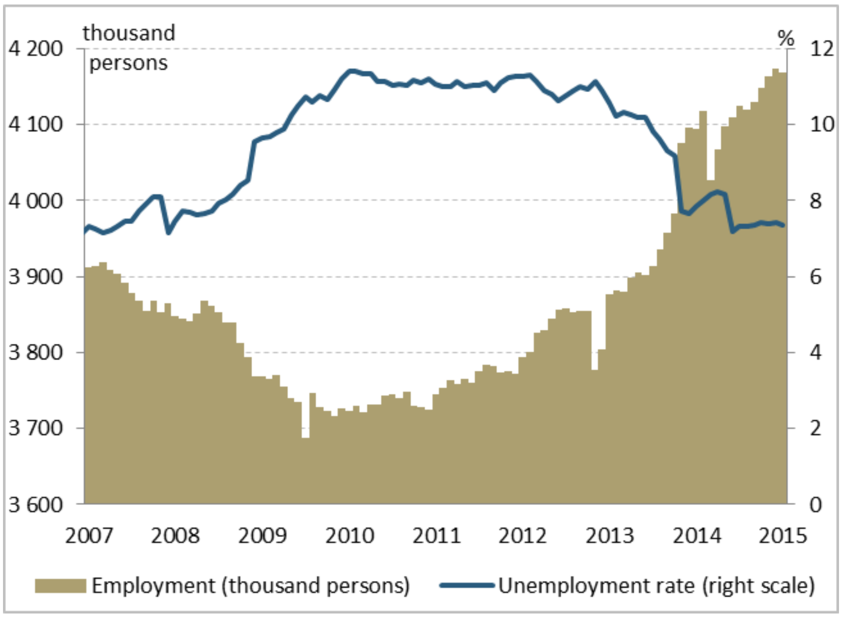
Consumption demand expanded further in this year's first quarter, which may be explained by the increase in real wages as a result of low inflation, by the improvement in the labour market situation and the upswing in retail sales volumes. According to preliminary data, retail sales continued to rise in March, exceeding the level observed in the same period of last year by 5 per cent. According to the structure of sales, turnover increased in a wide range of products in March. The sale of foodstuffs continued to recover in March, while the sale of non-food consumer durables further increased year-on-year, albeit at a slower rate than in the previous month, and materially contributed to the growth of the retail sales volume. Oil prices and thus the lower fuel prices may already have contributed to the increase in retail sales in a wider range of products as well.

The March baseline projection foresees continued growth with a balanced structure. 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. Economic growth may be supported by the recovery in domestic demand, the absorption of EU funds, loose monetary conditions and improving labour market conditions. Although moderate oil prices may boost growth in EU Member States, the protracted Russia-Ukraine conflict and declining economic growth in Russia and the Ukraine may point to a deceleration.

1.2.2. Employment

According to the LFS data, **in the first quarter of 2015 the number of employees in the total economy increased by 2 per cent year-on-year.** According to the preliminary data, employment in the private sector increased, explained by the higher number of employees working in market services. Public sector employment remained essentially unchanged. The **number of unemployed slightly decreased in the first quarter of the year** (Chart 6).

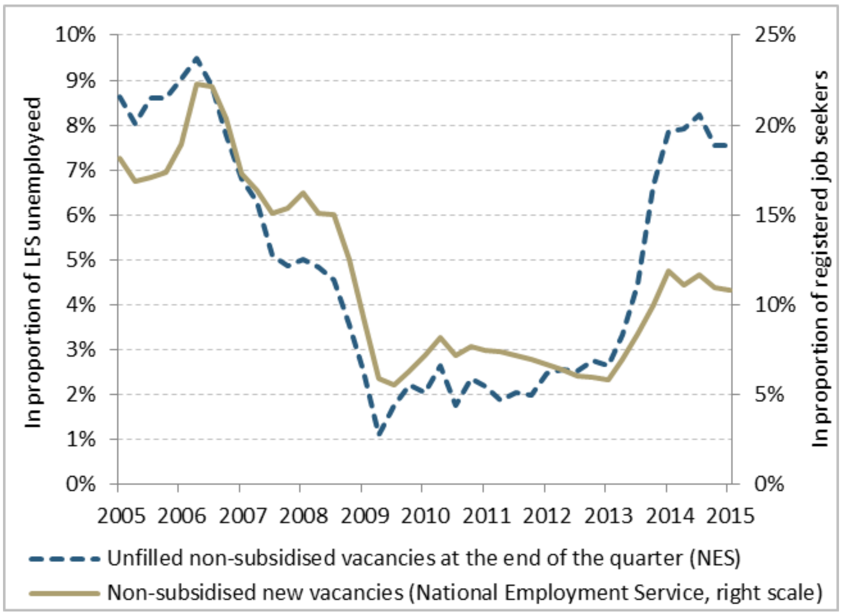
Chart 6: Number of persons employed and the seasonally adjusted unemployment rate



Source: HCSO

In the first quarter, both the number of newly announced non-subsidised jobs and the number of unfilled vacancies slightly increased compared to the previous quarter. **The labour market can still be considered tighter than at the beginning of 2013, although the process of tightening came to a halt in the course of 2014** (Chart 7).

Chart 7: Indicators of labour market tightness



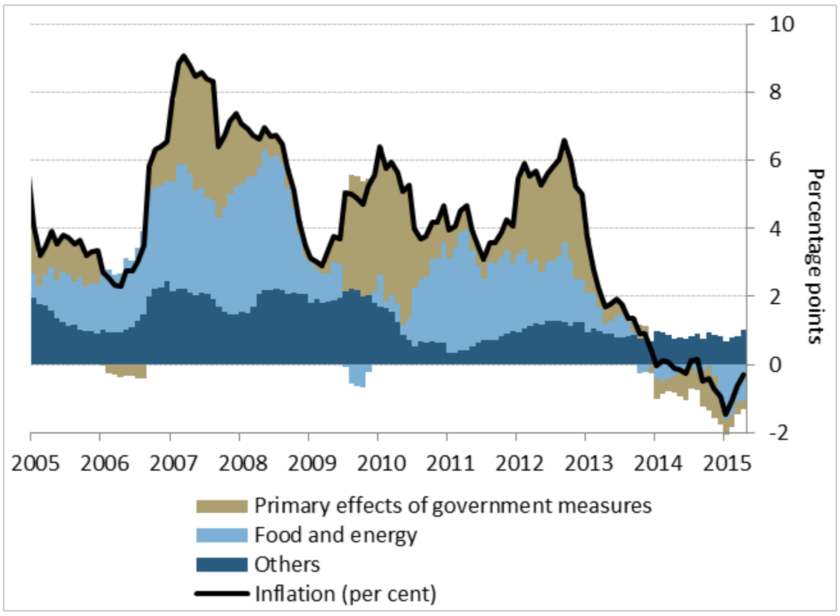
Sources: HCSO (Labour Force Survey) and National Employment Service

1.3. Inflation and wages

1.3.1. Inflation developments

In April 2015, inflation was -0.3 per cent, while both core inflation and core inflation excluding indirect taxes stood at 1.2 per cent (Chart 8). In the case of inflation the increase was primarily due to the increase of the price index of market services and unprocessed food.

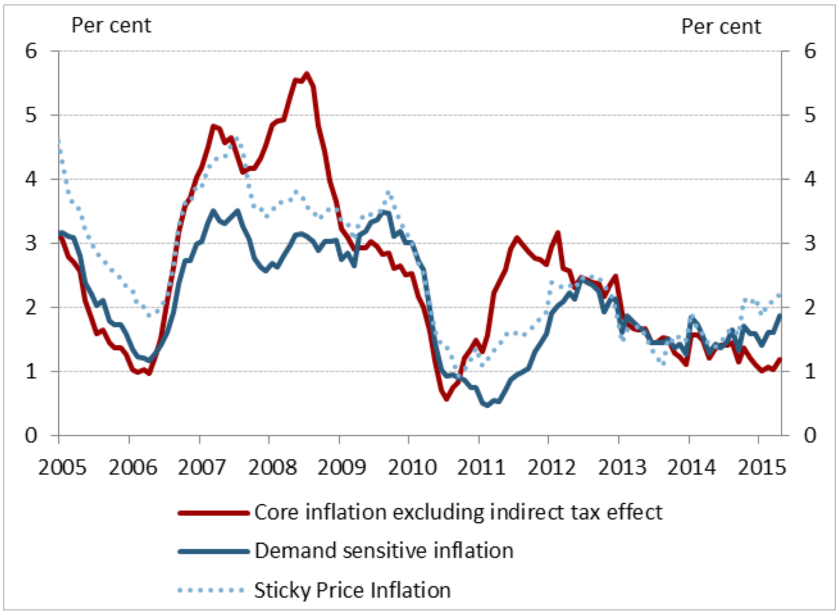
Chart 8: Decomposition of the consumer price index



Source: MNB calculations based on HCSO data

Moderate oil prices, low inflation expectations and moderate imported inflation may all have contributed to restrained underlying inflation in recent months (Chart 9). In March 2015, agricultural producer prices fell by 8.2 per cent in annual terms, while the domestic sales prices of the consumer goods sectors declined by 0.4 per cent relative to the same period of the previous year. In April, fuel prices did not changed substantially compared to the previous month. Based on retail sales data, consumption demand may have increased gradually in recent months, in parallel with the year-on-year rise in real incomes. This notwithstanding, the volume of retail sales still remained below pre-crisis levels. Consequently, domestic demand environment continues 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 is expected to remain close to 0 per cent in the short term. The April inflation figures were slightly higher than the expectations indicated in the forecast of the March *Inflation Report*, but due to low underlying inflation we expect moderate price developments in the coming months as well.

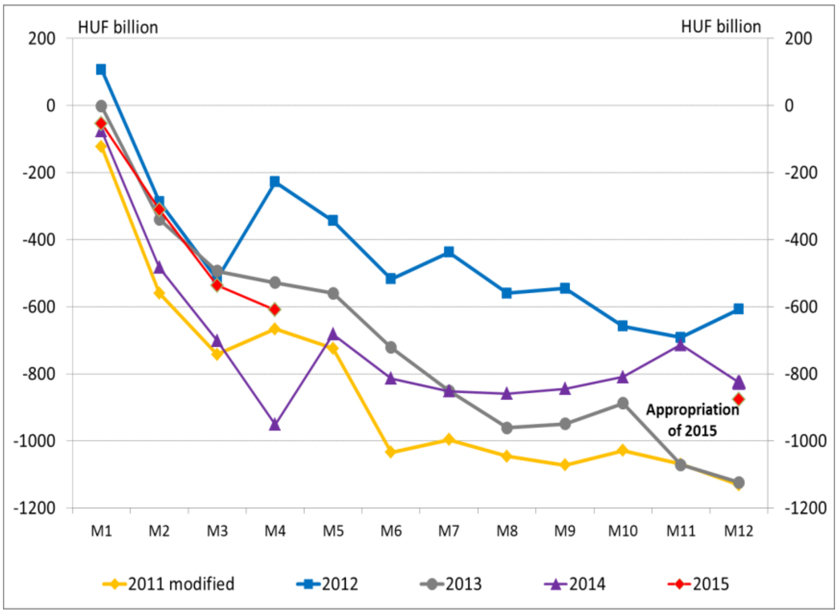
1.3.2. Wages

Gross private sector wages rose by 3.5 per cent in February compared to the same period of the previous year. Wage growth slowed compared to the previous months both in the manufacturing sector and in the market services sector. Bonus payments in the second month of the year were similar to those observed in previous years. **Gross private sector wages rose by 3.6 per cent in March compared to the same period of the previous year.** Wage outflow in the manufacturing sector was faster compared to previous months, while wage dynamics slowed in the market services sector. In the first quarter of the year, in line with the forecast, wage dynamics was more moderate than in the previous year. The wage figures of March, having special significance in terms of the annual wage setting, were in line with expectations.

1.4. Fiscal developments

In April 2015 the state budget closed with a deficit of HUF 73 billion (Chart 10); this is substantially more favourable than the value registered in April last year, which is attributable to the increase in fiscal revenues (primarily contributions) and lower expenditures. Savings on the expenditure side are mostly attributable to the fact that last year the transfers brought forward due to the bank holidays (public wages, benefits) represented a higher burden on the expenditures of April, and the one-off items (state subsidies) were also instrumental.

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



Source: Hungarian State Treasury

1.5. External balance

Based on the March figures the seasonally unadjusted external financing capacity – with a current account surplus of almost EUR 1 billion – amounted to EUR 1.4 billion. The improving balance of payments position reflected primarily the increased utilisation of transfers received from the EU, but the substantial goods and service surplus also contributed to the development of the historically high financing capacity.

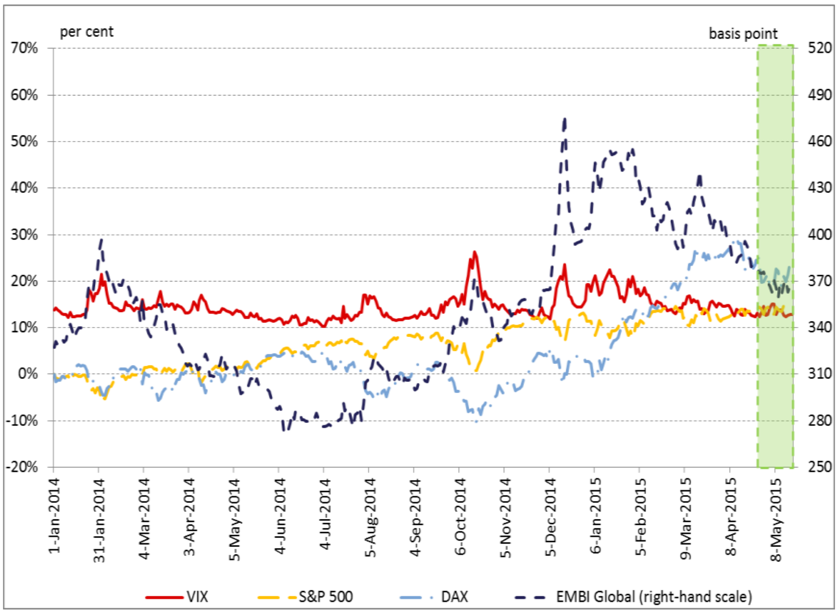
Based on financial account data the outflow of funds in March took place in parallel with a minor decrease in debt liabilities and a larger fall in net FDI funds, attributable to increased FDI outflows. In March the financing side processes reflected a lower, EUR 740 million, financing capacity, which was mostly attributable in the increase of the residents' foreign disinvestments. The moderate decline in net external debt is mostly related to the general government: in particular, it is attributable to the modest increase of foreign exchange reserves and the fall in the government securities held by non-residents.

2. FINANCIAL MARKET DEVELOPMENTS

2.1. International financial markets

In the period since the last interest rate decision **investment climate on the whole was mostly characterised by negative sentiment.** Risk appetite in Europe was primarily curbed due to the dragging-on of settling the situation of Greece in parallel with the increased chances of bankruptcy in Greece. The USA contributed to deteriorating sentiment by its unfavourable macro figures and persisting uncertainty related to the Fed's interest rate policy. Finally, in the emerging region the Russian economic downturn and moderate growth expectations in China also had a negative impact. These factors had different effects on the developed stock exchange indices: while the German DAX and the Japanese NIKKEI fell by 1-3 per cent, the fall of the US S&P500 adjusted by the period-end and could finish up 1.4 per cent. However, risk ratios did not reflect the deteriorating sentiment: the VIX Index, which measures developed equity market volatility, and the EMBI Global Index, which reflects the risks associated with the emerging bond markets, both abated (Chart 11). However, there was no decrease in the periphery countries of the euro area or in the regional risk indices.

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



Source: Bloomberg

Macroeconomic data received from the USA showed a mixed, but rather unfavourable overall picture. However, slightly positive figures were published for most of the euro area in the

period under review. Overseas the first quarter GDP growth rate, which was significantly less favourable than expected, the consumer confidence index, as well as labour market statistics caused disappointment. The weakening of the dollar, observed since mid-April, has materially accelerated after the publication of the US figures that suggest a slowdown; the Fed minutes could stop the depreciation only temporarily. Since the last interest rate decision the dollar lost 6 per cent of its value to the euro; thus the EUR/USD cross rate went up to 1.14 from previous close to par levels. Then, the last couple of days brought the strengthening of the dollar once again, as a result of which – after a 3 per cent adjustment – the cross rate fell close to 1.12.

Despite the weaker-than-expected US macro figures the date of the interest rate increase by the Fed has not been postponed substantially, although it is still surrounded by major uncertainties. The analyst surveys and the market interest rate expectations suggested by the fed fund futures quotes render the first interest rate increase probable in September. At the same time the Fed remains cautious in its statements and ties the potential move to an improvement in the labour market. **Based on the latest data, disinflation in the euro area seems to have reached a turning point:** according to the preliminary release for April, the decrease in prices came to a halt.

The failure of the negotiations between Greece and the Eurogroup on 24 April disappointed, albeit did not surprise, the market; however, the focus is still on the Greek finances: according to experts the parties must reach an agreement by June for Greece to avoid state bankruptcy. While earlier the Greek tensions left the peripheral yields unaffected, the recent increase in Italian, Spanish and Portuguese long-term yields imply that after all the infectious effect previously thought to be negligible has a slightly stronger impact.

In recent weeks, as a result of the higher inflation expectations and the natural market adjustment, a general increase in long-term yields could be observed both in the developed and emerging regions. The increase in yields in the euro area was determinant, which was accompanied – amongst other – by a 50 basis point increase of the ten-year benchmark yield, but the upward drift of the US ten-year yield by 20 basis points also represented a substantial move.

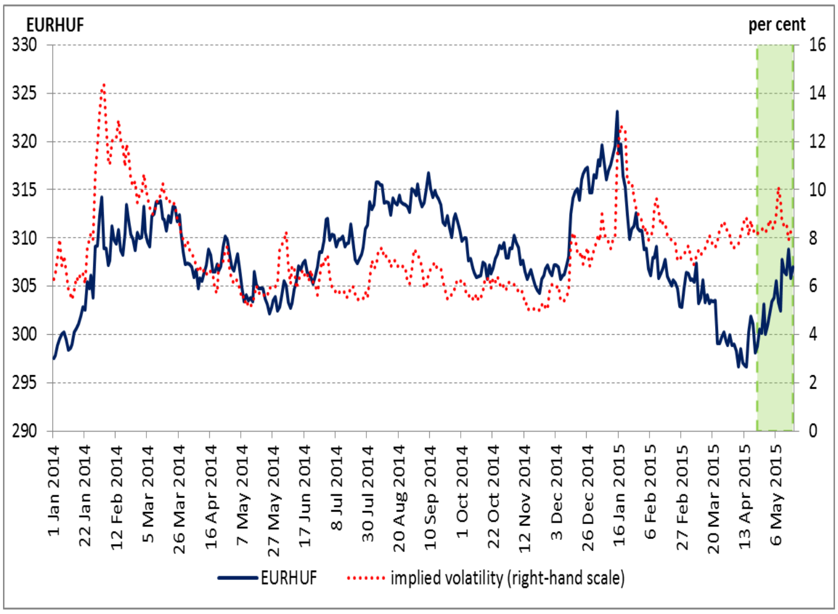
Due to the depreciation of the dollar and the lower-than-expected increase in the stock of crude oil **the oil market quotes rose by 6-9 per cent in the recent period.** Thus the price of Brent crude oil rose from USD 61.2 to USD 65.3, while that of the WTI from USD 53.3 to USD 59.

2.2. Developments in domestic money market indicators

Domestic money market sentiment was primarily influenced by international factors during the period under review; at the same time, country-specific impacts also prevailed. Domestic developments were significantly influenced by the news related to the settlement of the situation in Greece; apart from credit rating agencies' comments with regard to Hungary and the released macro figures, the revision of the European Commission's forecast also had a market-moving effect.

Since the latest interest rate decision the forint exchange rate has been volatile in parallel with the change in the global sentiments; in the period under review it weakened by 3 per cent in total. The EUR/HUF exchange rate reflected a continuous depreciation, increasing as high as 308 from around 300 recorded at the start of the period, with temporary adjustments. At the end of the period forint quotations were around 306.5 (Chart 12). Compared to the regional currencies, the forint weakened against the Polish zloty until the second week of May; thereafter there was a solid adjustment in zloty, thus the domestic currency became underperforming in the region.

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

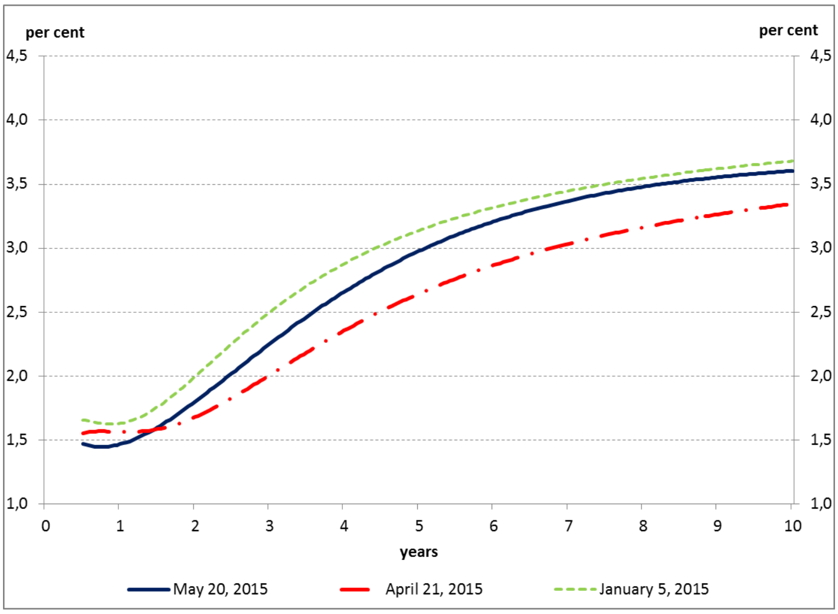


Source: Bloomberg

The macro figures published in the given period may be deemed favourable. The balance of trade figure for March was outstanding, showing a much higher surplus than expected. In the first quarter Hungarian GDP increased year-on-year by 3.4 per cent, in accordance with expectations. However, the GDP figure was received with mixed sentiment, since in the light of the macro figures received recently – suggesting a strong upturn of the economy – it somewhat fell short of the market expectations (on year-on-year basis it was consistent with the consensus). The European Commission revised Hungary's GDP forecast upward, but it expects a gradual slowing: according to the forecast, the 3.6 per cent growth of 2014 will be followed by weaker growth dynamics in 2015-2016 (by a GDP growth of 2.8 and 2.2 per cent). The Commission believes that with the closing of the output gap inflation may go up to 2.5 per cent in 2016, while the budget deficit may permanently remain below 3 per cent of the GDP on the forecast horizon, moreover, the government debt may fall below 74 per cent in 2016 from last year's 76.9 per cent.

As a result of the international influences there was a massive increase in the long-term yields in the Hungarian government securities market. During the period under review benchmark yields in the secondary market of government securities decreased for short-term maturities, while in the long-term segment a material yield increase by 30-35 basis points could be observed (Chart 13). The assumption that the domestic yield increase may be attributable to international impacts is supported by the fact that the yields in the core countries of the euro area and in the countries of the region increased at a similar rate as in Hungary. At 1.45 per cent, the three-month discount Treasury bill yield is still below the key policy rate, which implies a 10 basis-point dip since the previous interest rate decision. **Since the last interest rate decision the government securities yield curve became steeper** as long-term yields rose and short-term yields fell.

Chart 13: Shifts in the spot government bond yield curve



Sources: MNB, Reuters

Average yields remained essentially unchanged at government security auctions during the period. Average yields did not change considerably during the period at three-month and twelve-month Treasury bill auctions; their levels continued to fluctuate slightly below the base rate, at around 1.43-1.55 per cent. In the past weeks there was sound demand for the discount Treasury bills, with coverage varying between 1.5 and 2.5. The Government Debt Management Agency always accepted the announced volume during the short-term fund raising. Demand for long-term fixed-rate securities was strong, where on several occasions demands exceeded the coverage threefold. At the auctions held in the first weeks of May the Government Debt Management Agency regularly doubled the originally announced volume for three, five and ten-year papers as well. Demand at the auction of floating rate bonds was mixed; in the case of the five-year floating rate note the issuer accepted offers for a lower amount than announced, while offers for the three-year bonds were accepted for the planned issue. Average yields in the fixed-rate segment have increased materially, by 40-60 basis points, for all maturities.

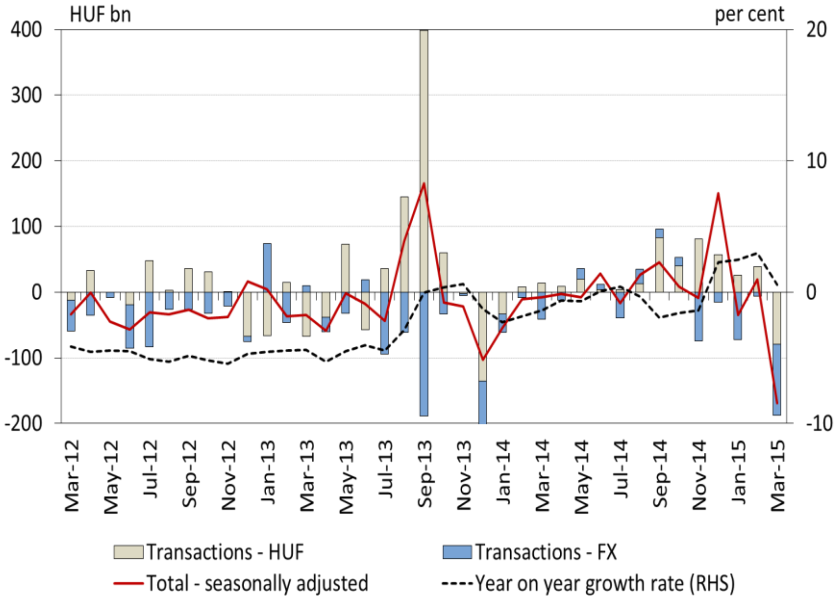
In the last two months holdings of government paper by non-residents fell by HUF 260 billion, thereby leaving the band of HUF 4,800-5,100 billion, which was typical recently. At present, foreign investors hold Hungarian government papers roughly in the amount of HUF 4,780 billion, therefore their share is below 45 per cent.

Hungary's risk assessment has not changed substantially during the period; the Hungarian five-year CDS spread is still quoted at around 140 basis points (Chart 15). During the period both Fitch and Standard & Poor's commented on Hungary's credit rating prospects. Fitch regarded the agreement concluded with EBRD, the high current account surplus and the debt reduction of the private sector as favourable developments. At the same time, it is of the opinion that the unpredictable business environment worsens the chances for positive developments. The other credit rating agency, S&P, voiced a similar opinion; it believes that the decision-makers should facilitate a business environment that is attractive for the foreign capital.

3. TRENDS IN LENDING

In March outstanding lending by credit institutions to the corporate sector decreased by a total of HUF 188 billion (HUF 169 billion seasonally adjusted) on a transaction basis, of which a major part is related to the repayment of a single syndicated loan (Chart 14). The transaction-based annual growth rate fell from 3 per cent registered in February to 0.6 per cent. Loans contracted under Pillar 1 of FGS accounted for HUF 21 billion in March.

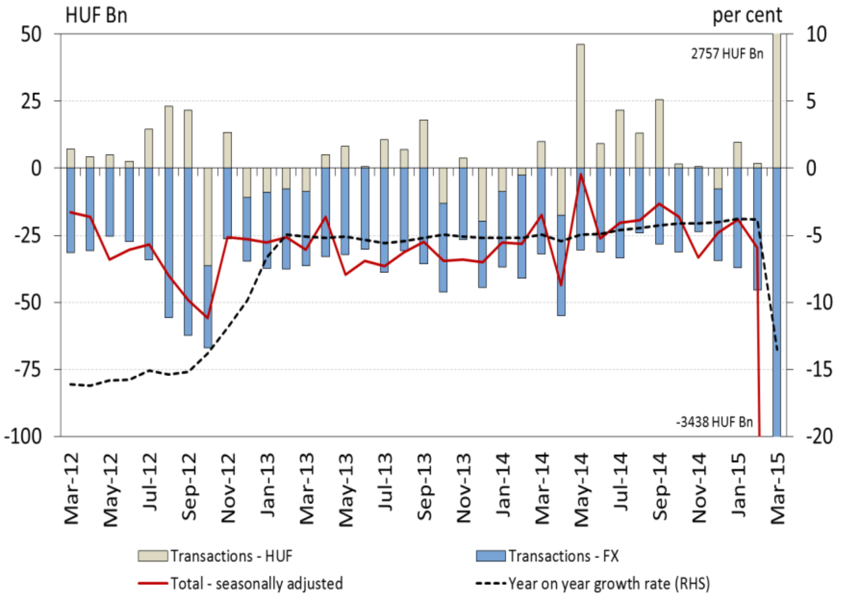
Chart 14: Net borrowing by non-financial corporations



Source: MNB

As result of the settlement households' outstanding borrowing decreased substantially; the value of loan transactions vis-à-vis the entire credit institution sector amounted to around HUF 680 billion (Chart 15). As a result of the conversion into forint the outstanding borrowing in forint increased by HUF 2,757 billion, while the foreign currency loan portfolio decreased by almost HUF 3,438 billion. Due to the settlement, the annual rate of decline in the loan portfolio increased to 13.5 per cent from 3.8 per cent measured in February.

Chart 15: Net borrowing by households



Source: MNB