Macroeconomic and financial market developments

June 2015

Background material
to the abridged minutes of the
Monetary Council meeting
13 June 2015

Time of publication: 2 pm on 8 July 2015

The background material 'Macroeconomic and financial market developments' is based on information available until 19 June 2015.

Article 3 (1) of the MNB Act (Act CXXXIX of 2013 on the Magyar Nemzeti Bank) defines achieving and maintaining price stability as the primary objective of the Magyar Nemzeti Bank. The MNB's supreme decision-making body is the Monetary Council. The Council convenes as required by circumstances, but at least twice a month, according to a pre-announced schedule. At the second scheduled meeting each month, members consider issues relevant to decisions on interest rates. Abridged minutes of the Council's rate-setting meetings are released regularly, before the next policy meeting takes place. As a summary of the analyses prepared by staff for the Monetary Council, the background material presents economic and financial market developments as well as new information which has become available since the previous meeting.

The abridged minutes and the background materials to the minutes are available on the MNB's website at:

http://english.mnb.hu/Monetaris_politika/decision-making/mnben_mt_jegyzokonyv

1. MACROECONOMIC DEVELOPMENTS

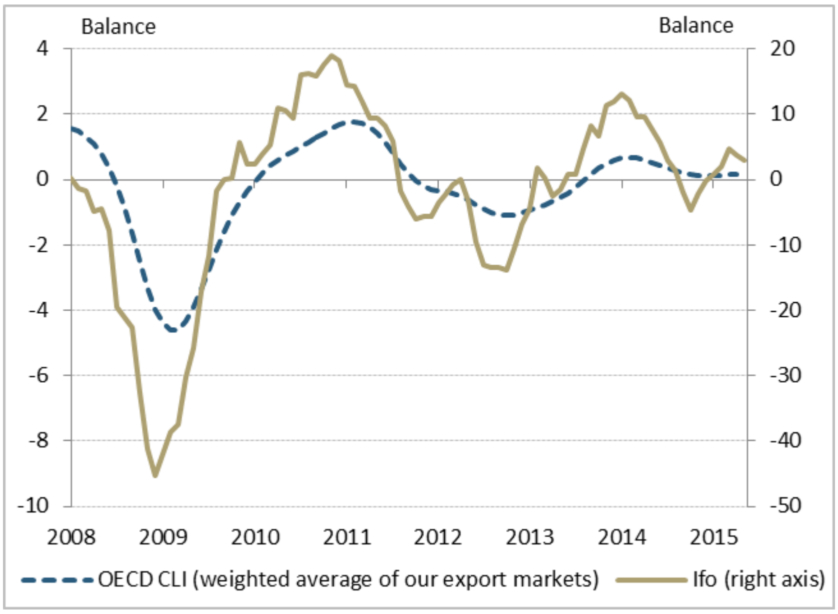
1.1. Global macroeconomic environment

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

The euro area economy registered a quarter-on-quarter growth rate of 0.4 per cent in the first quarter of 2015. The monthly production data received show a moderate upturn in the economic activity of the region. The forward-looking indicators of economic activity imply moderately improving performance. The tense geopolitical situation continued to have a negative impact on economic activity, which is restrained by the increasing insecurity and the bilateral economic sanctions. 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, increased moderately in the first quarter, while German domestic demand continues to expand; external market activity is curbed by the Russia-Ukraine conflict and the decelerating Asian demand. Expectations for German economic growth (Ifo) remained at the same high levels experienced in the previous months (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.

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

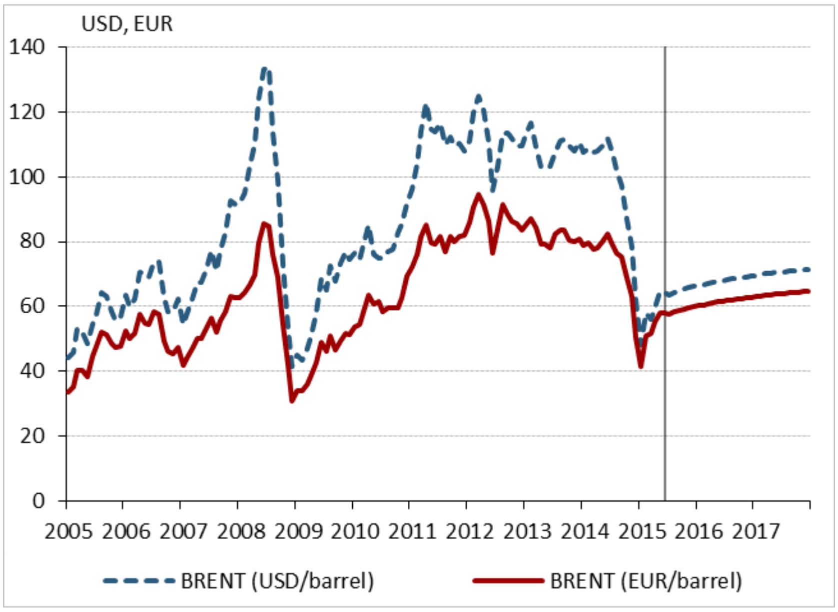


Sources: OECD, Ifo.

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 contraction in 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 growing world economy have reduced inflation. As a result, inflation rates remain below target in the world's major economies (euro area inflation stood at 0.3 per cent in May). The participants of the OPEC conference, the organisation of petroleum exporting countries accounting for about 40 per cent of the global oil production, held in Vienna on 5 June, decided to keep oil extraction at the same level, as a result of which the world market price of crude oil has not changed materially in recent weeks. On the whole, oil prices remain subdued, which – in addition to the increased supply – may be a result of the moderate demand experienced due to the slowdown in growth of mainly the major importer countries (Chart 2).

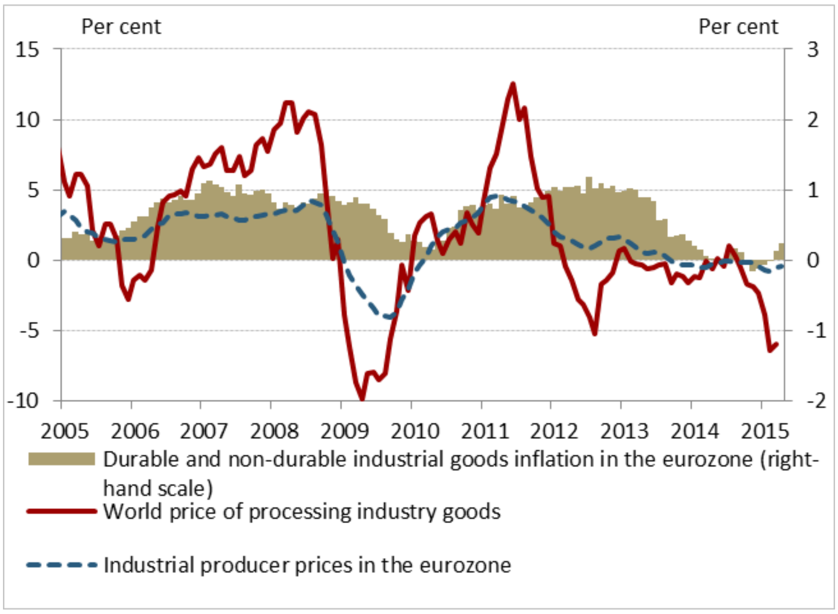
Chart 2: World market price of Brent crude oil



Source: Bloomberg.

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



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

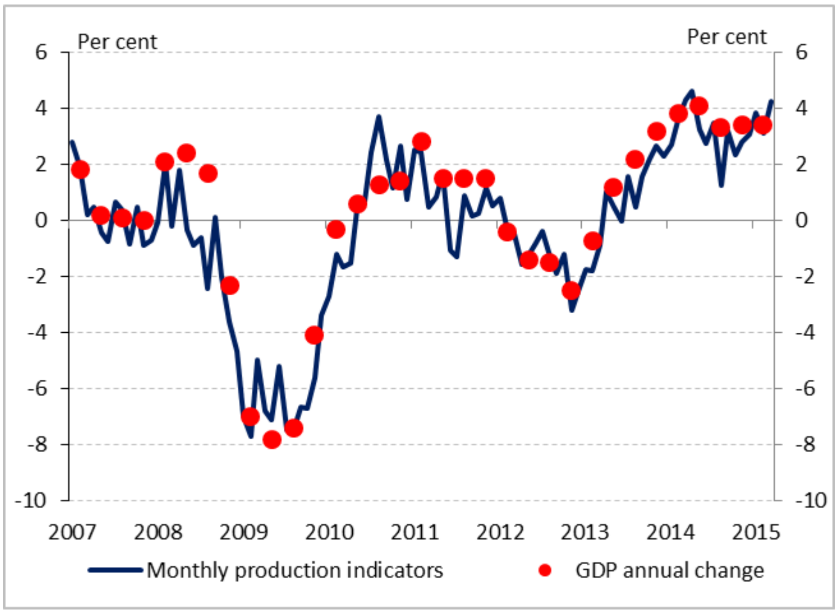
1.2. Domestic real economy developments

1.2.1. Economic growth

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

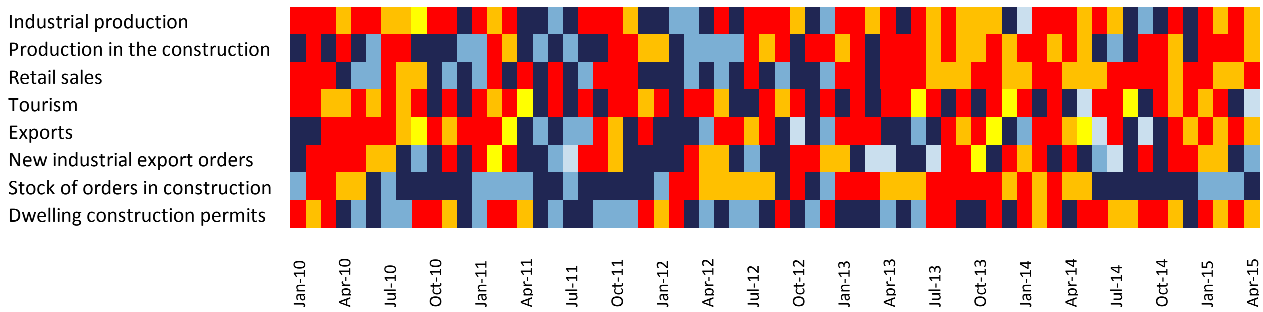
The manufacturing sector and services were the most important contributors to GDP growth. The increase in value added in manufacturing sector was still linked primarily to the increasing production of vehicle manufacturing and the related subsectors, while the expansion observed in a wide range of market services was boosted by recovering domestic demand. Construction still had a positive contribution to growth, albeit to a lesser extent than seen in the previous quarters (Chart 4). The estimated contribution of agriculture was negative in the first quarter due to the high base arising from last year's favourable harvest result. The HCSO estimates the value added by the sector in the first quarter based on technical assumptions; the final data will be determined depending on the harvest results of the next quarter.

Chart 4: Evolution of monthly production indicators and GDP*



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

*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 April 2015, industrial output rose by 6.3 per cent year-on-year. Seasonally adjusted production level excluding the working day effect was **0.1 per cent down compared to the previous month.** Production in the major manufacturing subsectors showed a varying picture. Forward-looking indicators give mixed signals with regard to the short-term prospects. The Eurocoin indicator, which shows the underlying trends of euro area economic activity, increased in April, while the value of the ESI indicator for the Hungarian economy and the Ifo, which reflects the outlook for the German economy, both fell in May, but they are still at a favourable level. The new export orders of the Hungarian industry continued to increase moderately in April 2015.

Denominated in euro, in April the value of **exports and imports increased by 8.9 per cent and 9.3 per cent, respectively, year-on-year**. The trade surplus exceeded its value registered in April last year. Under the decreasing export and import prices the terms of trade improved in March after the adjustment in February.

In April 2015 the volume of construction output rose by 10.8 per cent year-on-year, while seasonally and working-day adjusted **production fell by 1.2 per cent compared to the previous month.** 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.

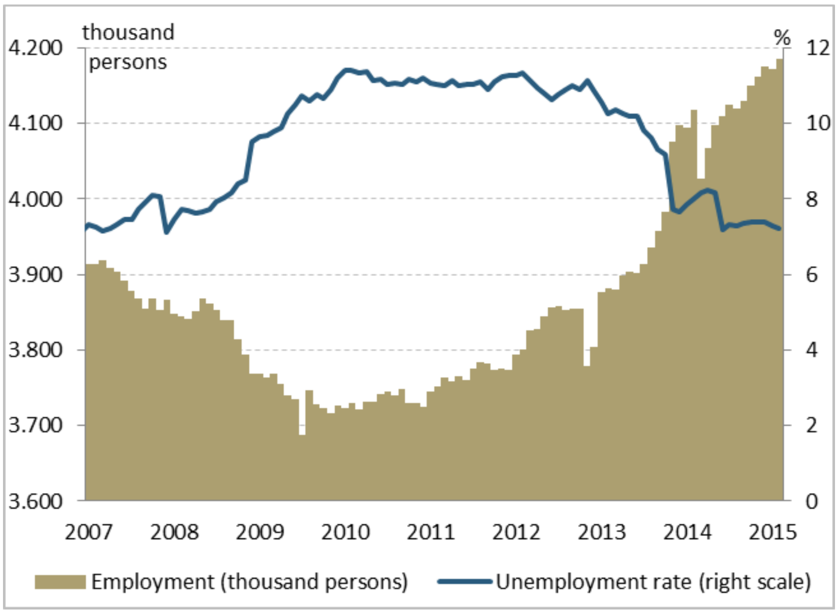
Consumption demand expanded further in the first quarter of this year and this trend may continue in the second quarter as well. This may be explained by the increase in real wages as a result of the improving labour market situation and low inflation, as well as by the upswing in retail sales volumes. According to preliminary data, retail sales continued to rise in April, exceeding the level observed in the same period of last year by 5.3 per cent. According to the structure of sales, turnover increased in a wide range of products. The sale of foodstuffs was more moderate than in the previous months; according to the raw data the turnover stagnated in April. The sales of non-food consumer durables have materially increased year-on-year and made a major contribution to the rise in retail sales volume. Fuel sales continued to increase in April on year-on-year terms. 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.

Based on the baseline projection of the June forecast the growth of the Hungarian economy continues. In addition to the substantial recovery in consumption, net exports may also make a considerable contribution to economic growth, while due to the ending of the EU funds, the investment activity may decelerate compared to the massive rate seen in previous years. 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 the improving labour market conditions. Although moderate oil prices may boost growth in EU Member States, the protracted Russia-Ukraine crisis and the declining growth in Russia and Ukraine may point to a deceleration.

1.2.2. Employment

According to the Labour Force Survey data **in April 2015, the number of employees in the national economy increased by 1.5 per cent year-on-year** (Chart 6). In the first quarter, private sector employment increased, which is explained by the higher number of employees working in market services. Public sector employment slightly decreased compared to the end of the year. The **number of unemployed decreased in April compared to the previous months**.

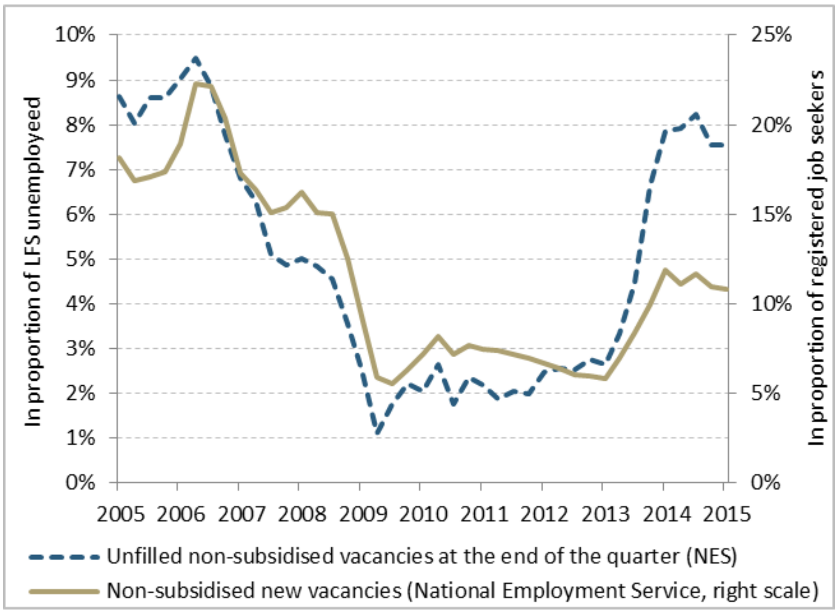
Chart 6: Number of persons employed and the seasonally adjusted unemployment rate



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 is still tighter than at the beginning of 2013** (Chart 7).

Chart 7: Indicators of labour market tightness



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

1.3. Inflation and wages

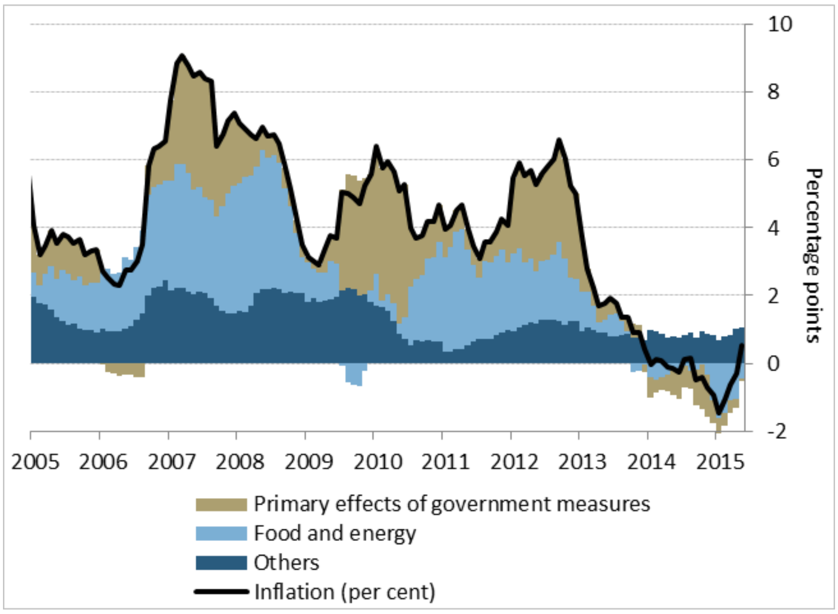
1.3.1. Wages

In April 2015 the wage index in the private sector was 4.1 per cent, that of the manufacturing sector 5.7 per cent and of the market services 2.9 per cent. In the case of the private sector and manufacturing sector these values are higher than the growth rate observed in previous months. The acceleration in the manufacturing sector is attributable to the higher than usual bonus payments in April.

1.3.2. Inflation developments

In May 2015, inflation was 0.5 per cent, while core inflation was 1.3 per cent 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 rising price index of fuel and unprocessed food, contributed to by the base effect in the area of regulated prices (elimination of the reduction of household gas prices last April from the base).

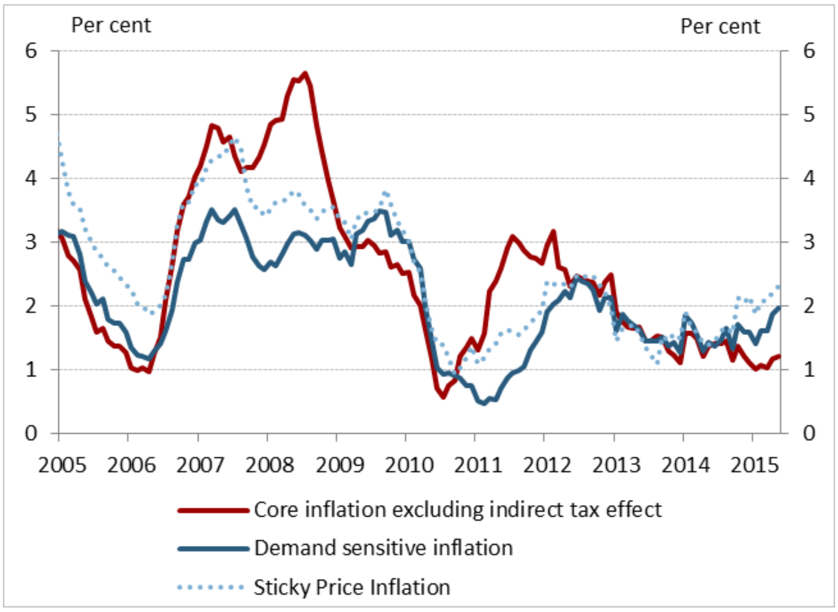
Chart 8: Decomposition of the consumer price index



Source: MNB calculations based on HCSO data.

The moderate oil prices, low inflation expectations and moderate imported inflation may all have contributed to restrained underlying inflation in recent months (Chart 9). In April 2015, agricultural producer prices fell by 8 per cent in annual terms, while the domestic sales prices of the consumer goods sectors declined by 0.2 per cent relative to the same period of the previous year. In May, fuel prices rose considerably compared to the previous month. Consumption demand, in line with the retail trade data, has increased gradually during the first quarter of this year, in parallel with the year-on-year rise in real income, which trend may have continued in the beginning of the second quarter as well. 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



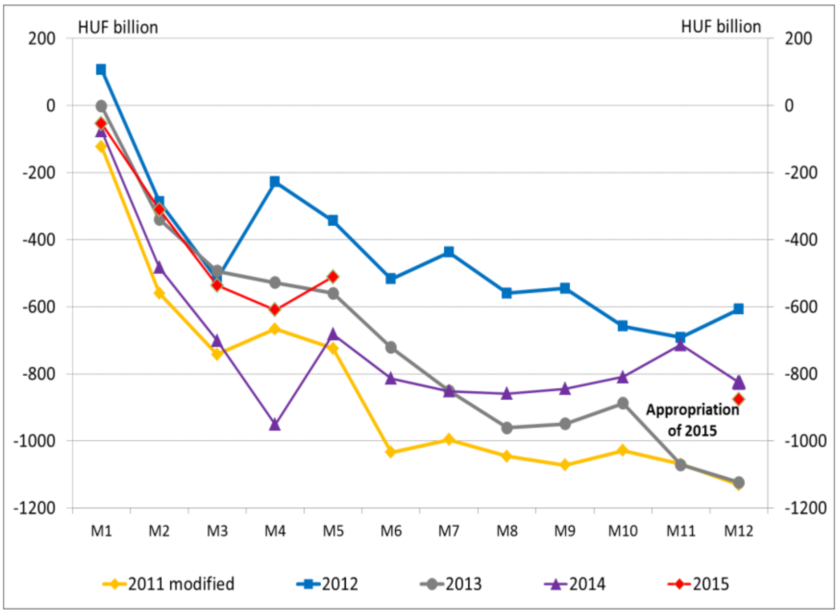
Source: MNB calculations based on HCSO data.

Inflation in Hungary is expected to remain in a slightly positive domain in the short term. The received data for May became higher than the expectations in the March Inflation Report. Looking ahead, in parallel with the ending of the extremely moderate cost effects and the recovery in demands, the inflation rate is expected to increase further.

1.4. Fiscal developments

The government budget closed May 2015 with a surplus of HUF 99 billion (Chart 10)**, which falls short of the surplus registered in May 2014, but it is much more favourable than the average of the previous years.** In May 2015 the revenues of the central subsystem of the general government increased by HUF 30 billion compared to the 2014 base, which is mostly attributable to the growth in contribution revenues. In May the expenditures of the central subsystem exceeded the value registered in May 2014 considerably, by HUF 201 billion, which is due to the fourth highest gross pay-out of the spending units in recent years, related to EU programmes. In addition, the increase in expenditures was attributable, to a lesser extent, to the fact that wage payments to healthcare workers (therapeutic and preventive care) were brought forward last year and paid already in April; however, this year it did not happen again.

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



Source: Hungarian State Treasury.

1.5. External balance

Based on the April figures, the seasonally unadjusted external financing capacity – with a current account surplus of EUR 500 million – amounted to EUR 750 million. The moderation of the external balance position is attributable to the decline in the goods surplus, and the lower utilisation of the EU transfers. However, the financing capacity was still high, which was mainly attributable – despite the decline – to the continued high goods surplus and the substantial utilisation of EU transfers.

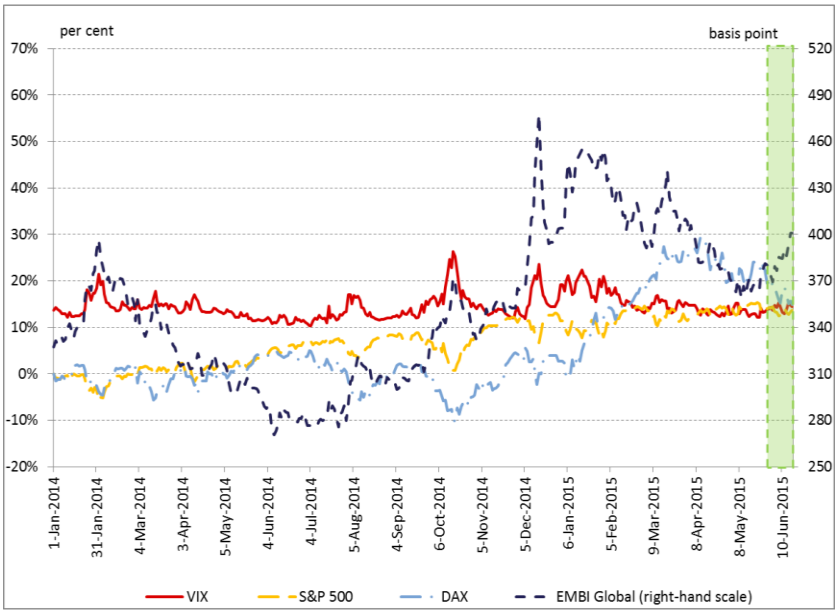
The financing data signal a lower – EUR 170 million – financing capacity, which developed under the continued decrease of debt-type funds and the inflow of direct capital funds. In April the net direct capital inflow amounted to more than EUR 300 million, which developed mostly under the increase of inter-company loans and the reinvested earnings. The outflow of debt-type funds amounted to more than EUR 500 million, which reflected the contraction of the banks' and corporations' external debt. The net external debt of the consolidated state has not changed under the increase in the margin account balance – which increases both the debts and foreign exchange reserves – and the stable government securities holdings of non-residents.

2. FINANCIAL MARKET DEVELOPMENTS

2.1. International financial markets

In the period since the last interest rate decision investor sentiments have deteriorated on the whole, the equity indices fell and aversion to risk has strengthened in the emerging bond markets as well (Chart 11). In Europe, the news flows – changing almost daily – with regard to the situation in Greece, as well as the macro figures of the euro area made a major contribution to the volatility of the euro exchange rate and the stock market indices. Uncertainties surrounding the Fed interest rate path still persist in the USA due to the mixed macro figures, although as a result of the latest, favourable labour market data and the press conference held after Fed's interest rate decision in June, expectations render an interest rate increase in September probable. The MSCI indices, measuring the performance of the developed and emerging equity markets registered a decline throughout the period, where the fall was stronger in the case of the latter one. The rise of the global emerging market bond index (EMBI) – and thereby the decreasing risk appetite as regards the emerging countries – presumably was attributable to the news about the potential additional economic sanctions against Russia, the result of the Turkish elections and the increasing concerns about the debt settlement of Ukraine.

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 picture, while positive figures were published for most of the euro area in the period under review. Since the last interest rate decision the dollar depreciated by 4 per cent against the euro, thus the EUR/USD cross rate rose close to 1.14, which was presumably attributable to the favourable activity data of the euro area and the mostly mixed data reported by the USA. At the same time, the favourable labour market figures of May – which reflected a much higher growth in employment in the United States than expected — could have pointed to the Fed interest rate increase in September. In Europe one of the most important data published in the period was the harmonised index of consumer prices for May. This was the first time since last November that inflation rose to the positive domain in the euro area, while core inflation went up to 0.9 per cent in annual terms, thereby outpacing both the previous month's data and the expectations. According to ECB's latest macroeconomic projection average inflation in 2016 may be 1.5 and in 2017 1.8 per cent – i.e. close to ECB's inflation target – while economic growth next year and in 2017 may be around 2 per cent.

The position of Greece and the international organisations with regard to the composition has not come closer in the past period either, thus it is becoming increasingly probable that no final, reassuring agreement will be reached with regard to the settlement of Greece's debt in June either. The severity of the financing situation is reflected by the fact according to the announcement made in the beginning of June, Greece wishes to pay the four instalment of June due to IMF in one sum at the end of June to the Monetary Fund. In response to this, a few days later S&P, the credit rating agency, changed Greece's CCC+ rating to CCC still with negative outlook.

The global increase in long-term yields, observed at the end of April, beginning of May, gathered renewed momentum in June, which impacted both the developed and the emerging regions. The 10-year German Bund yield went up by 20 basis points during the period under review, while the yields of the periphery countries rose at an even higher pace (35-65 basis points). In addition, UK and US yields also showed an increase of 10-15 basis points. An increase of 35-70 basis points could be observed in our closer region, which is roughly similar to that of the periphery.

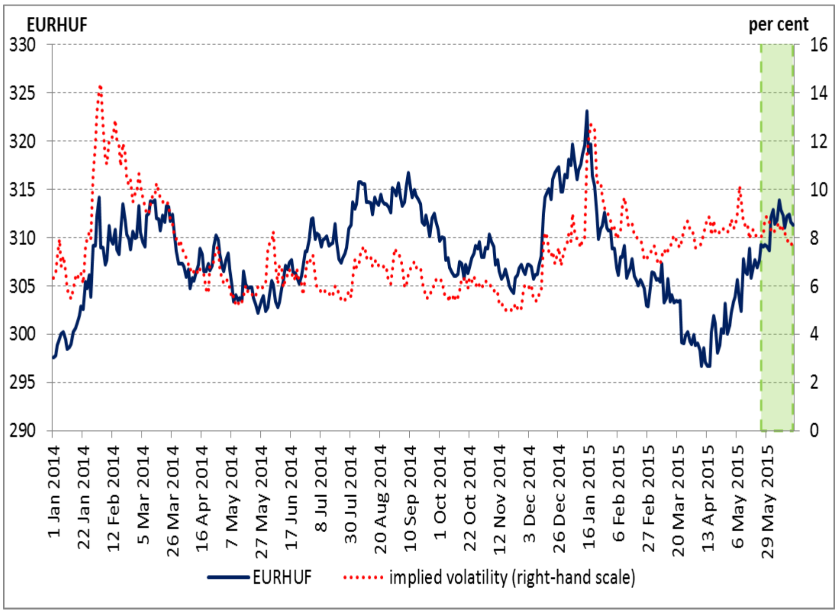
Oil prices were impacted by opposite processes, thus no clear-cut trend could be observed in their movement. The OPEC conference in the beginning of June, as well as the reports published lately by the US Energy Information Administration and the International Energy Agency (IEA), had the largest impact on the prices. On the whole, further increase in oil extraction may be expected both in the OPEC countries and the United States; meanwhile IEA has upwardly revised its global demand forecast for the entire year. The price of the Brent and WTI crude oil rose by 2-4 per cent during the period under review. However, considering the longer term processes, it appears that the oil price increase observed since mid-March cannot exceed the level of USD 60-65 permanently, and the experts do not expect any substantial price increase in the second half of the year either.

2.2. Developments in domestic money market indicators

The domestic money market sentiments were primarily influenced by the international factors during the period under review; at the same time, country-specific impacts also prevailed.

Since the last interest rate decision the forint exchange rate was volatile in parallel with the change in the global sentiments; on the whole it weakened against the euro by about half per cent (Chart 12). The EUR/HUF quotations reflected a continuous depreciation, increasing as high as 313 from 309 recorded at the start of the period, under temporary adjustments. At the end of the period forint quotations were around 311. Compared with the regional currencies, the forint followed a similar path as the Polish zloty; however, due to the substantial strengthening of the Polish currency in the beginning of the period, the domestic currency slightly underperformed in the region.

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

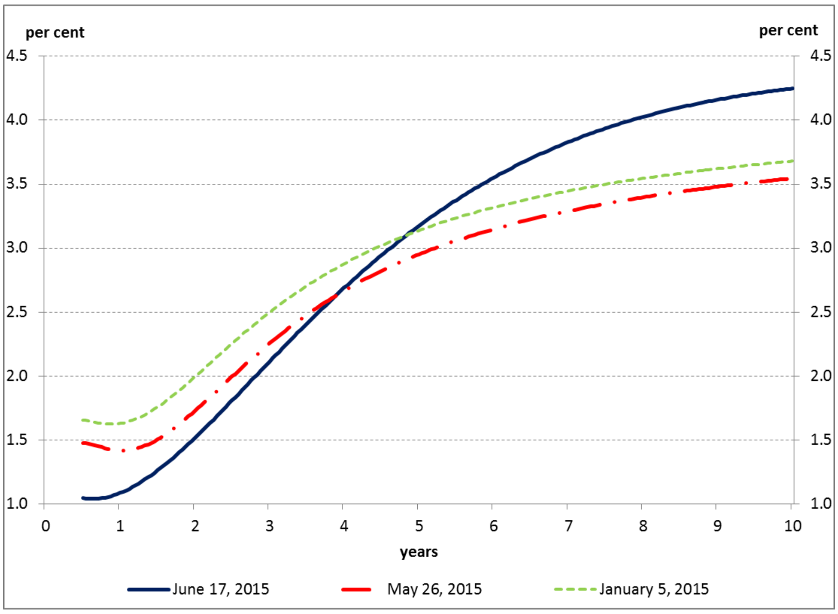


Source: Bloomberg.

The domestic macro figures published in the period under review were mostly favourable. The inflation outcome of 0.5 per cent, published in May, was an upward surprise for the markets; after its publication several economists upwardly revised their inflation projection. Gross domestic product increased by 3.5 per cent in the first quarter of 2015 year-on-year, while after seasonal adjustment the growth was 0.8 per cent compared to the previous quarter. The growth was primarily attributable to the increase in household consumption and the recovery of net exports. However, the whole-economy fixed investments showed a negative picture, as the volume thereof fell by 4.5 per cent in the first quarter of 2015 year-on-year, while the volume after seasonal adjustment decreased by 1.1 per cent compared to the previous quarter.

As a result of the international impacts there was a massive increase in the long-term yields in the Hungarian government securities market. During the period under review there was a substantial decrease, i.e. 30-45 basis points, in the yields for short-term maturities and a 15-35 basis points decrease in the yields of the 1-3 year segment in the secondary market of government securities. On the other hand, long-term yields increased substantially, by 70 per cent. The 10-year benchmark yield rose by almost 70 basis points to over 4 per cent. The decline in short-term yields coincided with the announcement of the reform of MNB's policy instruments, while the long-term yield increase may be attributable to the rise in global yields. At close to 1 per cent, the three-month discount Treasury bill yield is still below the key policy rate, which implies an almost 45 basis-point dip since the previous interest rate decision. **Since the last interest rate decision the government securities yield curve became steeper** under the increased long-term yield and the decreasing short-term yields (Chart 13).

Chart 13: Shifts in the spot government bond yield curve



Sources: MNB, Reuters.

During the period under review yields decreased at the government security auctions in the short-term segments and increased in the case of the long-term securities. Average yields at the 3-month treasury bill auctions fell by more than 30 basis points, and at the auction of the 12-month paper by almost 30 basis points during the last month. In the past weeks there was a sound demand for the sale discount treasury bills, with coverage varying between 2 and 3. On one occasion the Government Debt Management Agency increased the volume of the 3-month and on another occasion that of the 12-month discount Treasury bills it planned to issue, while in all other cases it accepted the announced volume during the short-term fund raising. There was also a strong demand at the auctions of the long-term fixed-rate securities; the coverage was more than threefold on each occasion, and the Debt Management Agency regularly increased the issued volume of the three-, five- and ten-year securities. Average yields in the fixed-rate long-term segment have decreased materially, by 10-30 basis points, for all maturities since the last interest rate decision.

The government securities holdings of non-residents fell by further HUF 220 billion in total in the last month; at present non-residents hold Hungarian government securities roughly in the amount of HUF 4,450 billion, thereby representing a share below 42 per cent. Despite the sale, the increase in the Hungarian long-term yields was in line with the regional trends.

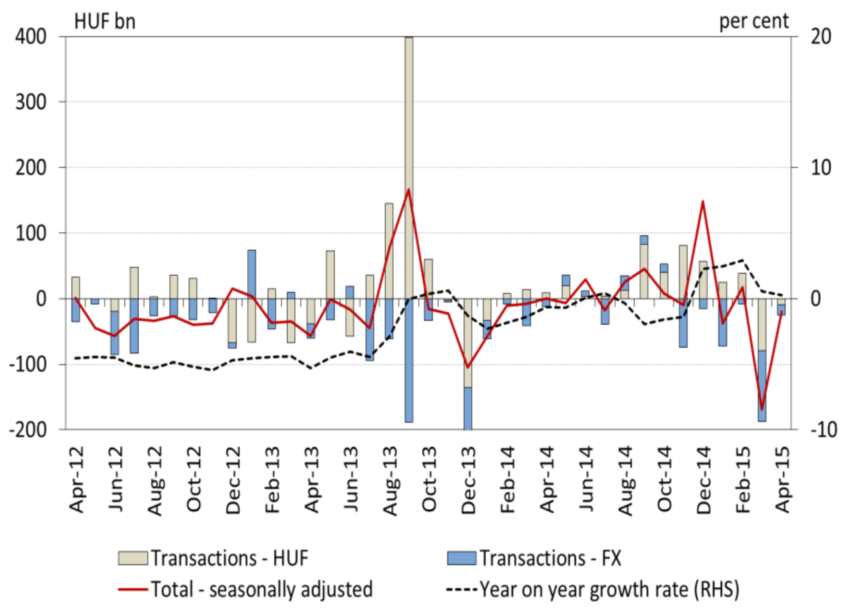
Hungary's risk assessment has not changed materially during the period; the Hungarian five-year CDS spread increased; at present it is quoted at around 155 basis points. According to our decomposition methodology the increase in the risk spread is attributable to international factors, while the country-specific reasons pointed to the decrease of the risk spread.

3. BANKING SYSTEM

3.1. Trends in lending

In April the outstanding lending by credit institutions to the corporate sector decreased by a total of HUF 26 billion (seasonally adjusted by HUF 20 billion) on transaction basis (Chart 14). The decline in the forint and foreign currency loans outstanding was HUF 10 billion and HUF 16 billion, respectively. The transaction-based annual growth rate fell from 0.6 per cent registered in February to 0.2 per cent. Loans concluded under Pillar 1 of FGS contributed around HUF 25 billion to the corporate lending in April.

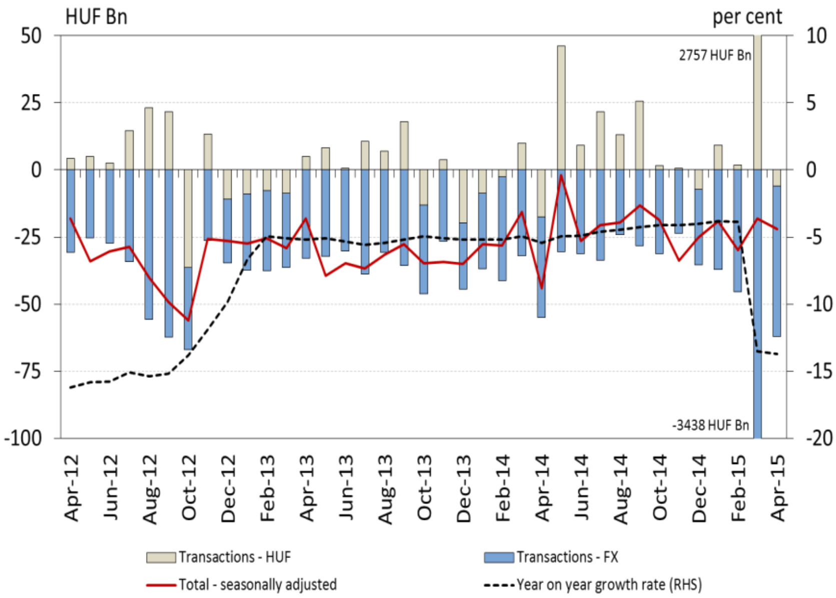
Chart 14: Net borrowing by non-financial corporations



Source: MNB.

The value of the loan transactions against the entire credit institution sector amounted to roughly HUF -62 billion (Chart 15). With this, the annual rate of decline in loans outstanding increased from 13.5 per cent in March to 13.7 per cent. The volume of new loans issued amounted to HUF 48 billion in April, which represents a 6 per cent increase year-on-year.

Chart 15: Net borrowing by households



Source: MNB.