Macroeconomic and financial market developments

February 2016

Background material to the abridged minutes of the Monetary Council meeting of 23 February 2016
Time of publication: 2 am on 9 March 2016

The background material ‘Macroeconomic and financial market developments’ is based on information available as at 19 February 2016.

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 usually twice a month, according to a pre-announced schedule. At the second scheduled meeting each month, members consider issues relevant to decisions on interest rates. Abridged minutes of the Council’s rate-setting meetings are released regularly, before the next policy meeting takes place. As a summary of the analyses prepared by staff for the Monetary Council, the background material presents economic and financial market developments, as well as new information which has become available since the previous meeting.

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

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

1.1. Global macroeconomic environment

Countries in the region grew dynamically in the fourth quarter of 2015, with euro area growth continuing at a rate similar to that of previous quarters. Based on the incoming indicators, in recent months growth in emerging economies may have decelerated compared to earlier expectations. Growth remains fragile surrounded primarily by downside risks. The outlook for growth of emerging regions compared to pre-crisis levels has slackened. Large commodity exporting countries may continue to be hit by low commodity prices in the coming quarters. Persisting geopolitical tensions may continue to restrain growth in developed countries through weaker demand and economic sanctions.

The euro area economy registered a quarter-on-quarter growth rate of 0.3 per cent in the fourth quarter of 2015. Economic growth in Germany, Hungary’s most important export partner, remained at the rate seen in the previous quarters. Domestic demand in Germany may have grown further, but external market activity may have been curbed by the Russia–Ukraine conflict and the slowdown in demand in Asia. In December, the decline of the previous months was followed by an upturn in German industrial production. Expectations concerning the German economy (Ifo) have slightly deteriorated compared to the previous months (Chart 1).

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

Sources: OECD, Ifo.
The region kept up its favourable performance in the last quarter of 2015 as well. The negative effects of the Russia–Ukraine conflict may have had only a limited impact on growth in the CEE region so far, but looking ahead, the expected significant contraction in the Ukrainian and Russian economies carry both direct and indirect risks to economic growth in the region.

Inflationary pressure from the world market remains weak. The fall in commodity prices combined with weak global demand are reducing inflation. As a result, inflation rates remained below target in the world’s major economies. In January, oil prices continued to fall (Chart 2; for more details see subsection 2.1).

**Chart 2: World market price of the Brent crude oil**

The world market prices of industrial commodities and unprocessed food were moderate, while the prices of manufactured goods somewhat adjusted after a considerable fall (Chart 3).
1.2. Domestic real economy developments

1.2.1. Economic growth

The growth of the Hungarian economy in the fourth quarter of 2015 accelerated compared to previous quarters according to preliminary data. Hungary’s GDP was up 3.2 per cent year on year, with a 1 per cent growth recorded relative to the previous quarter.

With the exception of agriculture and construction, all sections of the national economy may have contributed to the rate of GDP growth year on year. According to the monthly output data available, industrial production and retail sales were up from the previous quarter, while construction remained level (Chart 4). Crop yields suggest that the contribution of agriculture may have been negative to economic growth in 2015, which is primarily due to the previous year’s high base.

On the expenditure side, the recovery of domestic demand may have continued. Retail data suggest continued growth in household consumption in the fourth quarter, while housing market figures indicate a slowdown in household investment activity relative to the previous quarter. Corporate investment activity may have remained subdued as the spill-over effects of previous large investments faded. Our goods exports were up from the previous quarter, in line with the improving performance of the automotive industry and the increase in Hungarian industrial
orders. Over the quarter, import dynamics stagnated at a level below that of export dynamics. Overall, the contribution of net exports to growth may have increased relative to the previous quarter.

*Weighted average of monthly production indicators (industrial output, construction output and retail sales). The weights are derived from regression explaining GDP growth.*

Sources: MNB calculations based on HCSO data.

After the slowdown at the end of the year, the HuCoin indicator, which marks the underlying trends of Hungarian economic activity, recovered in January, followed by a slight correction in February (Chart 5).
Due to the GDP data revision, the historic values of the HuCoin indicator may have also changed.
Sources: HCSO, MNB calculations.

Chart 6: Growth heat map*

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

In December 2015, industrial output was up 9.4 per cent year on year, and down 0.7 per cent compared to the previous quarter. Compared to November, the performance of manufacturing subsectors showed a mixed picture. The output of vehicle manufacturing and electronics increased, coupled with a decline in food industry output. Overall, forward-looking indicators suggest a favourable outlook on the short term. The EuroCoin indicator, which marks the
underlying trends of European economic activity, recorded a higher reading with favourable developments in Hungarian export orders. However, there may be a risk from the subdued performance of the German industry, which is in line with the fall of the Ifo indicator in January.

Expressed in euro terms, in December 2015 exports and imports increased by 7.3 and 1 per cent, respectively, year on year. Balance of trade surplus was up EUR 398 million from last December. Overall in 2015, expressed in euro terms the volume of exports increased by 7.4 per cent and that of imports by 5.6 per cent, generating an EUR 1,809 million increase in trade surplus. In November, low energy prices remained the largest contributor to the improvement in the terms of trade.

In December 2015, the volume of construction output increased by 8.1 per cent year on year, while the seasonally and working-day adjusted figure rose by 2.3 per cent compared to the previous month. December saw a meaningful increase in the volume of new contracts, primarily due to a significant increase in the number of contracts for the construction of buildings. Growth was supported by contracts for sports, educational and industrial facilities.

The pick-up in consumption demand observed last year may have continued into the fourth quarter as well. This may be explained by the improving labour market situation and by the increase in real wages as a result of low inflation, as well as by the upswing in retail sales volumes. In December, according to preliminary data, sales volumes increased by 5.3 per cent year on year, while the increase in turnover was 0.8 per cent compared to the previous month. In December, retail sales may have increased in a wide range of products. In addition to the non-food consumer durables, food sales may also have made a major contribution to the expansion of retail sales volume. Fuel sales increased at a slower rate compared to the previous months. In international comparison, domestic sales were overall positive at a rate comparable to that measured in countries across the region.

1.2.2. Employment

According to Labour Force Survey data, in the fourth quarter of 2015 the number of employees in the national economy rose by 2.8 per cent year on year. The participation rate did not change substantially compared to the previous quarter. The unemployment rate was 6.1 per cent in December (Chart 7).
In the fourth quarter a preliminary sectoral breakdown indicates continued growth in the private-sector employment. Within the private sector, the growth in employment was attributable to the processing industry, while there was no substantial headcount change in the market services sector. There was a slight decline in public-sector headcount compared to the previous quarter.

In the fourth quarter of 2015, the number of newly announced non-subsidised jobs was slightly lower than in the previous quarter, accompanied by a moderate decrease in the number of vacant non-subsidised jobs for the quarter. Various tightness indicators suggest continued tightening in the labour market in recent years (Chart 8).
1.3. Inflation and wages

1.3.1. Wages

In December, the annual wage dynamics in the private sector decreased relative to the previous month. The decrease in the annual dynamics of gross average wages is explained by a slowdown in the dynamics of the market services sector.

1.3.2. Inflation developments

In January 2016, inflation was 0.9 per cent, while core inflation was 1.5 per cent and core inflation excluding indirect taxes stood at 1.3 per cent (Chart 9). In the case of inflation, the rise in the fuel price index due to base effects was counterbalanced by a decrease in the price index of unprocessed food due to a cut in pork VAT.
Underlying inflation indicators continue to point to a moderate inflation environment, which may be attributable to the low level of imported inflation, low oil prices and the magnitude of unutilised capacities (Chart 10). In December 2015, agricultural producer prices rose by 5.2 per cent in annual terms, while the domestic sales prices of the consumer goods sectors increased by 0.7 per cent year on year.
Based on incoming data, underlying inflation trends were essentially in line with our previous expectations. This was accompanied by lower inflation, primarily due to a major decline in commodity prices since last December. The difference in inflation is explained by developments in the price index of vehicle fuels, and the more moderate price dynamics of unprocessed food. The prices of market services increased moderately, which, looking ahead, may call for more muted dynamics than expected. **Recent weeks’ major fall in oil prices presents a downside risk to the short-term forecast of the December inflation report.** Looking ahead, inflation may significantly fall short of the 3 per cent target and may approximate it only by the end of the forecast horizon.

**1.4. Fiscal developments**

The surplus of the central subsystem of the general government stood at HUF 92 billion in January 2016, representing a positive balance relative to the same period of the previous years (Chart 11). The budget balance of January 2016 represents a significant improvement of HUF 146 billion on the balance of January 2015, which is due to a lesser extent to increased revenues, and to a greater extent to a lower level of expenditures.

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

The tax and contribution revenues of the central subsystem were 5 per cent higher than in January 2015, which is primarily attributable to the dynamic increase in revenues from consumption taxes and contributions year on year. In the case of the value added tax, the
dynamic growth in gross collections continued into January, resulting in a 7.5 per cent revenue increase year on year. The increase in gross VAT revenues may be explained by a number of factors: first, favourable macroeconomic developments, including the rise in household consumption, which is also confirmed by the dynamic growth in retail sales; second, a hike in disbursements of EU grants at the end of last year; and third, the effect of measures aimed at formalising the economy.

On the expenditure side, the amount of net expenditures related to EU projects was lower than in last January as a result of phasing out the period of 2007 to 2013, and the slower start to payments related to the new period of 2014 to 2020.

1.5. External balance
According to the December data release, the seasonally unadjusted external financing capacity fell to EUR 630 million, with surpluses of EUR 450 million and EUR 180 million in the current and capital accounts, respectively.

Financing data indicate a financing capacity that is slightly higher than that of the real economy, amounting to EUR 770 million. The outflow of funds was generated in the context of a decrease in net external debt amounting to approximately EUR 1 billion, and slower net FDI outflows. The minor decrease in foreign direct investment, amounting to EUR 35 million, was a result of higher foreign investments by residents, and lower investments by foreigners. In December foreign equity investments further increased by approximately EUR 200 million. The approximately EUR 1 billion decrease in net external debt was primarily due to the more than EUR 2 billion reduction in the external debt of the banking system, while companies also reduced their debt by some EUR 0.6 billion. In contrast with the decrease seen in previous months, net external sovereign debt was EUR 1.7 billion higher, largely attributable to a fall in reserves. At the end of the year, reserves were reduced by the maturity of the premium Euro Hungarian government bonds (PEMÁK), as well as by the FX swap with the banking sector.
2. FINANCIAL MARKETS

2.1. International financial markets

The market sentiment was primarily determined by global fears over growth and inflation, the volatility of oil prices, the interest rate decision of the Japanese central bank, shifting market expectations on the Fed’s next rate hike, and another round of easing by the ECB, expected in March. Following the improvement in sentiment in late January, equity markets fell in the second half of the period, and lack of confidence in emerging bond markets intensified significantly (Chart 12). As a result of a global decline in investor sentiment and of uncertainty over the Fed’s future interest rate path, the US stock market indices have typically fallen since the previous interest rate decision, but have overall been able to rise by 1.5 to 2 per cent; following the improvement at the beginning of the period, markets fell as sentiment soured, despite which a major correction followed at the end of the period. In the middle of the period, European and Japanese indices were still 6 to 10 per cent in the negative, and in the case of the latter, the rise in the stock market resulting from Japan’s monetary easing proved was only temporary. However, due to a sharp upward correction at the very end of the period, the indices overall closed 1 to 5 per cent below their initial levels. Primarily, European stock markets were unfavourably influenced by negative news on operators in the banking sector. On the currency market, the dollar steadily depreciated against the euro amid deflationary fears and uncertainty over the Fed’s next interest rate hike. However, the end of the period saw a slight correction in the EUR/USD rate from 1.135 to around 1.11. As risk appetite waned, the Japanese yen and the Swiss franc, both considered to be safe-haven currencies, appreciated.

Following a temporary improvement at the end of January, global risk appetite on the whole deteriorated during the period, driving down the prices of risky assets, and resulting in a meaningful increase in the prices of safe-haven assets. A measure of stock market volatility, the VIX index recorded a substantial increase, returning to around 22 percent by the end of the period, its typical level at the time of the previous interest rate decision. Following a decrease at the end of the period concerned, the emerging market bond spread as measured by EMBI Global returned to 538 basis points in the second half of the period, a level last seen in 2008–2009. Also as a result of increasing risk aversion, gold appreciated by 8 per cent, accompanied by a decrease of 17 to 20 basis points in long-term yields in developed markets. Ten-year yields fell to 1.66 percent in the US and 0.18 per cent in Germany, levels last seen in spring 2015. Although
temporarily, ten-year Japanese yields dipped into negative territory. Subsequently, as risk aversion became slightly weaker, long-term yields in developed markets have also increased to a degree but keep fluctuating around the lows recorded a year ago, while the Japanese yield, presumably due to deflationary fears and expectations for further monetary easing, remained around zero per cent at the end of the period.

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

At its meeting in late January, the Bank of Japan decided on a negative policy rate. Applying a cut of 20 basis points, the Japanese central bank reduced the rate of interest payable on newly accumulated excess reserves on the current accounts of commercial banks with the central bank to -0.1 per cent, simultaneously introducing a three-tiered reserve system. The central bank indicated that it would apply further interest rate cuts if required. After a temporary depreciation following the decision, the Japanese yen appreciated steadily, possibly supported by intensifying risk aversion on a global scale, driving the rate of the yen 3 to 4 per cent above the dollar by the second week of February.

The Fed’s interest rate policy remained unchanged; however, expectations for the Fed’s next interest rate hike have increasingly shifted back as a result of falling oil prices and international deflationary concerns. While market pricing in the last days of January suggested that at least
one interest rate hike was probable this year, by mid-February expectations indicated a mere 30 per cent probability for a hike even in the Fed’s December meeting. In its latest meeting, the Bank of England adopted a unanimous decision to leave its policy rate unchanged, adjusting its growth and inflation forecast downwards. The uncertainty over the future interest rate policy of the BoE may partly be due to swinging expectations about the outcome of the referendum to be held this year on the United Kingdom’s EU membership.

**News from the US labour market are mixed.** The number of non-farm employees fell significantly short of expectations, and the previous month’s reading has also been revised downwards. At the same time, unemployment fell to 4.9 per cent from 5 per cent, with average hourly wages outperforming expectations with a rise of 0.5 per cent on a monthly basis (2.5 per cent year on year). As new applications for unemployment benefits remain below the psychological threshold of 300,000 with new jobs up from the previous month, the overall situation of the labour market continues to be seen as adequate. Although the GDP estimate for the fourth quarter fell short of expectations (with an annual growth rate of 0.7 per cent in the last quarter), for the whole of 2015 GDP may have been up 2.4 per cent from the previous year. Nevertheless, manufacturing industry activity remains subdued, and the services sector, performing well previously, took a sudden downturn in January despite the ISM Purchasing Managers’ Index indicating continued growth.

**Inflation reading improved slightly for Europe.** The January inflation reading for the euro area was up 0.4 per cent year on year in line with expectations, with core inflation at a somewhat higher-than-expected 1 per cent. Long-term inflation expectations have fallen significantly in the recent period (similarly to developed economies outside the euro area), intensifying expectations for further ECB easing. In line with expectations, the GDP reading for the fourth quarter was 1.5 per cent for the euro area on an annual basis, despite which both the Ifo business sentiment index and the Sentix investor sentiment index for the euro area moved lower, indicating a deteriorating economic outlook. The same trend is followed by manufacturing industry orders and retail sales in Germany, both falling short of expectations.

**Oil prices were moved primarily by news on supply.** In late January, the rise in oil prices was driven primarily by news of proposed talks involving OPEC members and non-OPEC countries, while the growth in US oil reserves significantly outperforming expectations, and reporting on a
further increase in OPEC production in January sent the price back on a downward track. At the end of the period, as a result of expectations around talks on production between Russia and some OPEC members, the price of Brent rose again, consolidating after volatile trading at 7 to 8 per cent above the level recorded at the time of the previous interest rate decision (USD 31.8). Compared to the start of the year, both types of oil lost a significant 7 to 17 percent of its value. Due to an increase in Iranian production, the drop in January in Chinese oil imports, and the cyclical nature of oil consumption (in the months of spring, oil consumption drops worldwide), downside risks remain dominant for the short term.

2.2. Developments in domestic money market indicators

In the past period Hungarian asset prices were primarily driven by international factors, with only a minor effect from domestic reporting. The somewhat lower-than-expected inflation reporting may have pushed down prices temporarily, while following the GDP reporting for the fourth quarter the next day, which was significantly higher than expert estimates, prices appreciated slightly. However, such effects are difficult to segregate from international trends, given the similarity of price movements across the region in the periods concerned, which was presumably in response to EUR/USD movements and fluctuations in international risk appetite.

During the period, the EUR/HUF rate moved between the 309 and 314 levels, appreciating by about 1 per cent overall. The temporary depreciation after the previous interest rate decision was followed by gradual appreciation, allowing the rate to approximate HUF 310 by the end of the period. A similar appreciation was observed across the region, presumably as a result of expectations for further easing by the ECB in March. The strongest performance was shown by the złoty, appreciating by nearly 2 percent relative to its price at the beginning of the period. As the USD rate gradually declined, regional currencies appreciated against the dollar by about 2.5 to 4 per cent (Chart 13).

Analysts responding to a Reuters survey in early February expect a somewhat weaker HUF/EUR rate around 314 on the short term of 3 months, and a rate gradually appreciating to about 309 over the longer term of 6 to 12 months.
Relative to the date of the previous interest rate decision, the short end of the yield curve moved 10 to 25 basis points up, with the middle and long sections moving 10 to 25 basis points down (Chart 14). During the period, benchmark yields in the market of short-term (3, 6 and 12-month) government securities rose above 1 per cent from their initial levels of 0.9 to 0.95 per cent, with the 12-month treasury bill recording the greatest increase of some 25 basis points, and the 3-month bill recording 11 basis points. The movement of long-term yields was influenced by the Government Debt Management Agency (ÁKK) shifting the benchmark for the 3-, 5- and 10-year reference bonds, which resulted in a temporary hike in yields. Adjusted for this technical effect, 5 and 10-year yields were down 20 basis points and the 3-year section of the curve was down 8 basis points.
In the first half of the period, demand was moderate at auctions for short-term government securities, intensifying in the second week of February. The first half of the period saw muted sales of 3-month treasury bills, with demand hardly exceeding the amount issued. In the second half of the period, demand intensified to cover 2 to 2.5 times the amount offered at each auction. At the last auctions, yields averaged at around 1.08 per cent, representing an increase of 10 basis points relative to the average yield at the beginning of the period. Demand was similarly subdued at auctions for 12-month bills. In the case of long-term treasury bonds, no clear trend emerged in the period, and interest in floating-rate securities also remained moderate.

Non-residents’ holdings of government securities decreased further by roughly HUF 200 billion since the last interest rate decision, as a result of which the size of their portfolio fell below HUF 3,640 billion, corresponding to a share of about 27.4 per cent within the total HUF government bond portfolio in the market. As international sentiment soured, the 5-year CDS premium rose to 165 basis points by the end of the period. Our decomposition methodology suggests that the slight increase of 5 points may primarily be attributable to international effects, while the domestic component remained a downward force.
3. TRENDS IN LENDING

In December, outstanding loans to enterprises decreased by HUF 247 billion in total as a result of transactions, equivalent to a decrease of HUF 30 billion after seasonal adjustment (Chart 15). In terms of denomination, forint loans increased by some HUF 62 billion, while foreign currency loans decreased by HUF 185 billion. To a great extent, the decrease is attributable to portfolio cleaning by a large bank; however, despite being removed from the balance sheet of the credit institution sector, the amount remains within the Hungarian financial intermediary system in the broader sense. Consequently, the portfolio of the credit institution sector was reduced at an annual rate of 6.7 per cent, which, adjusted for the one-off effects above, is equivalent to reduction at an annual rate of 2 per cent.

Chart 15: Net borrowing by non-financial corporations

By contrast, our estimate based on preliminary data suggests an annual increase of 3.6 per cent in the loan portfolio of the SME segment in December (Chart 16). In combination, Pillar I of the FGS and FGS+ made a HUF 68 billion contribution to portfolio growth in the period concerned.
In December, in the case of newly granted corporate loans, the average interest rate on small-value forint loans was down 0.42 percentage points to 4.19 per cent from November, while the average interest rate on higher-value forint loans increased by 1.26 percentage points to 2.95 per cent.

**Outstanding loans of the household segment vis-à-vis the credit institutions sector as a whole declined by HUF 50 billion as the result of loan transactions** (Chart 17). Outstanding forint loans and total foreign currency loans fell by HUF 49 billion and HUF 1 billion, respectively. The drop in forint loans outstanding is largely attributable to a fall in forint overdraft facilities, which was caused by early wage payments in December. In December, loans outstanding decreased at an annual rate of 15.1 per cent, equivalent to 4.5 per cent when adjusted for the current effects of settlement and HUF conversion.
In December, interest rates on new household loans increased slightly. The annual percentage rate of charge (APRC) on HUF housing loans increased by 0.16 percentage point to 5.94 per cent, while the APRC on HUF general purpose loans rose by 1.4 percentage points to 8.7 per cent.

Sources: MNB.