Macroeconomic and financial market developments

August 2015

Background material
to the abridged minutes of the
Monetary Council meeting
25 August 2015

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The background material 'Macroeconomic and financial market developments' is based on information available until 18 August 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 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

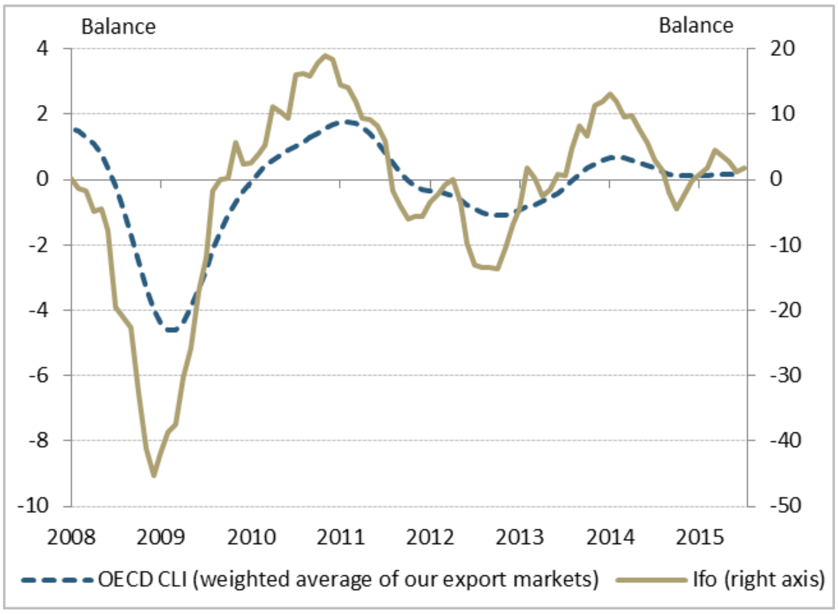
1.1. Global macroeconomic environment

GDP data in the second quarter of 2015 were slightly lower than expected. Based on the incoming indicators, in recent months growth in the developing countries may have decelerated compared to earlier expectations. 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 may slow growth in developed countries through weaker demand and economic sanctions. Uncertainties surrounding the expected interest rate increase by the Fed may moderate investors' interest in emerging markets. Low oil prices may boost growth in oil importing economies, while having an unfavourable effect on oil exporters' growth prospects. Inflationary pressure from the world market has remained weak in recent months as a result of moderate oil prices.

Growth in the world economy continued in the second quarter of this year. The highest growth rates in the EU were registered in the countries of Central and Eastern Europe. The adverse effect of the Russia–Ukraine conflict has continued to impede economic growth through weaker demand and economic sanctions extended until January 2016. In addition, based on the incoming indicators growth in the developing countries may decelerate compared to previous expectations.

The euro area economy registered a quarter-on-quarter growth rate of 0.3 per cent in the second quarter of 2015. The monthly production data received show a moderate upturn in economic activity of the region. Although the forward-looking indicators of economic activity imply moderately improving performance, the protracted management of the Greek situation may affect the economic performance of the euro area negatively. In addition, the tense geopolitical situation may also have a negative impact: increasing uncertainty and bilateral economic sanctions may restrain economic activity. These factors may have contributed to the fact that economic expansion continued at a more moderate rate than in previous quarters. Economic growth in Germany, Hungary's most important export partner, accelerated in the second quarter, but was still moderate. Domestic demand in Germany continued to grow, but external market activity may have been curbed by the Russia–Ukraine conflict and the slowdown in demand in Asia. Expectations concerning the German economy (Ifo) improved slightly in June following the decline in previous months (Chart 1). Overall, the average increase in new orders in the German industry was modest in the past months.

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

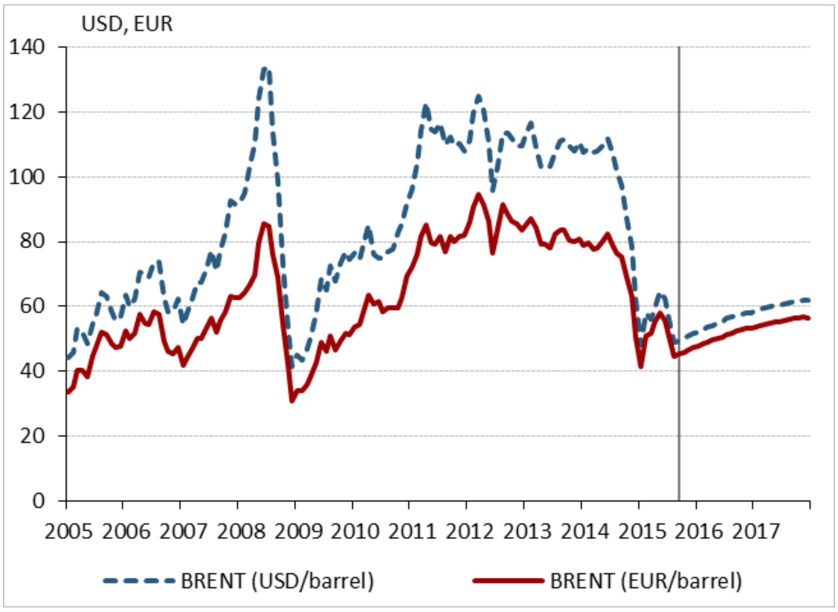


Sources: OECD, Ifo.

The performance of the region was outstanding in the second quarter of this year but, according to the monthly indicators of recent months, industrial output is still fragile in the region. 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 may, both directly and indirectly, hinder economic growth in the region.

Inflationary pressure from the world market remains weak. The decline in commodity prices, combined with slowly growing world economy, are reducing inflation. As a result, inflation rates remain below target in the world's major economies (euro area inflation stood at 0.2 per cent in July). In recent weeks, oil prices continued to decrease further, which was attributable to both demand and supply factors (see more details on this in subsection 2.1) (Chart 2).

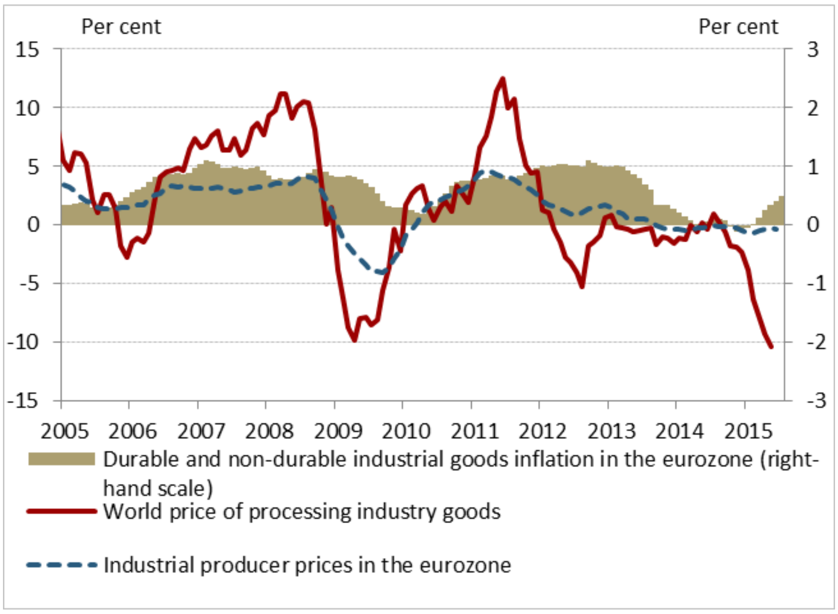
Chart 2: World market price of the Brent crude oil



Source: Bloomberg.

The world market prices of industrial commodities and unprocessed food were restrained, while there was a sharp fall in the price of manufactured goods (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.

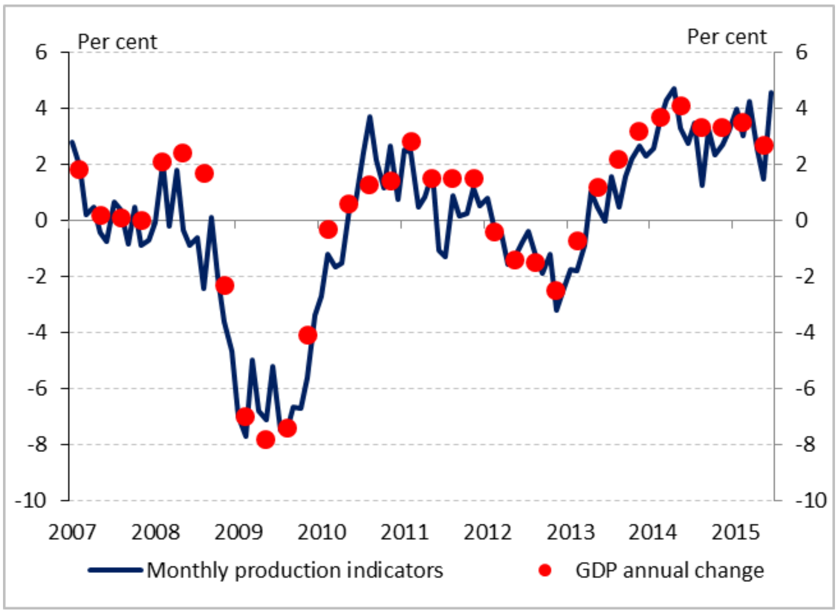
1.2. Domestic real economy developments

1.2.1. Economic growth

The Hungarian economy continued to grow in the second quarter of 2015. Preliminary data indicate that Hungary's GDP was up 2.7 per cent year on year, with a 0.5 per cent growth rate recorded relative to the previous quarter. Some guidance on the sectoral output and demand sides may only be provided by the indicators related to previous months.

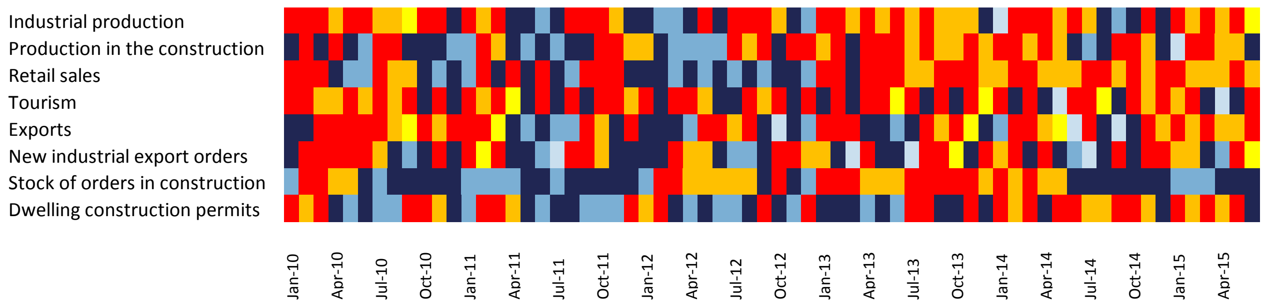
Based on the monthly production indicators, economic growth may have slowed slightly in the second quarter of this year (Chart 4). Industry and the construction sector may have continued to contribute positively to GDP growth, albeit to a lesser extent than in the first quarter. In addition, according to HCSO, slower economic growth than in the previous quarter may have been attributable primarily to the weaker performance of agriculture.

Chart 4: Changes in 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 June 2015, industrial output rose by 11 per cent year on year. Seasonally adjusted production, excluding the working-day effect, was **up 1.1 per cent compared to the previous month.** In June, the **performance of the manufacturing subsectors showed a favourable picture.** Of the major subsectors, output of the manufacture of transport equipment, light industry and metal industry increased, while that of the food and chemical industries decreased compared to the previous month. The fall in output of the chemical industry was mainly attributable to the decrease in coke production and in output of crude oil processing. Overall, based on the forward-looking indicators, the gradual pick-up in the euro area may continue in the coming months, with the possible support of lower oil prices and the accommodating monetary policy of the ECB. Signs of a deceleration in global economic activity and the Russia-Ukraine conflict may still pose downside risks with regard to the economic prospects of the euro area.

Expressed in euro terms, in June the value of **exports and imports increased by 13.4 per cent and 8.9 per cent, respectively, year on year**. The trade surplus exceeded significantly its value registered in June last year. Export prices increased slightly while import prices fell, which resulted in an improvement in the terms of trade. The improvement may be attributable primarily to the falling oil prices.

In June 2015, **the volume of construction output rose by 10.2 per cent year on year**, while seasonally and working-day adjusted **output increased by 0.5 per cent compared to the previous month**. In the second quarter, output exceeded that of the first quarter of 2015 by 1.0 per cent. The performance of the sector is expected to be moderate in the second half of 2015, which may be attributable both to the steady decline of nearly one year in the book of contracts and last year's high base. Approaching the end of the 2007–2013 EU programming period, infrastructural projects financed from EU funds may be accomplished gradually in the course of the year.

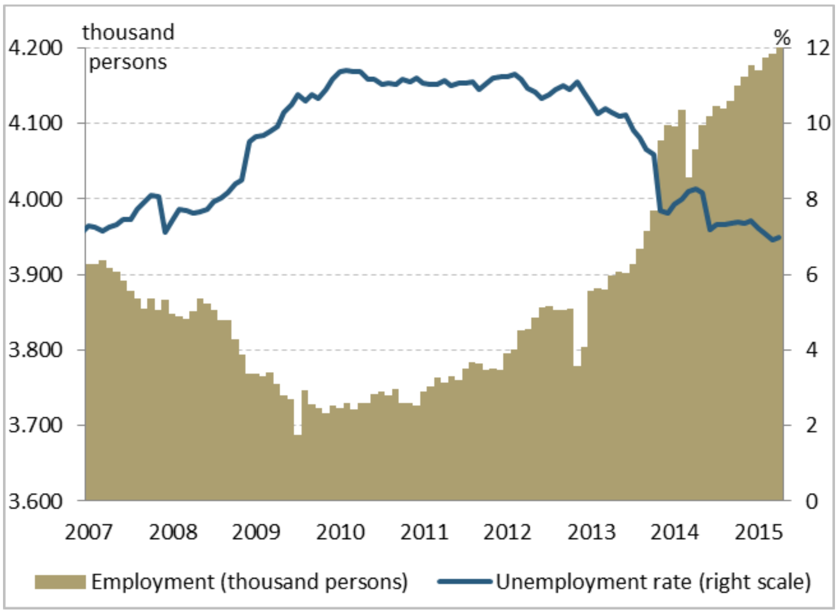
Consumption demand expanded further in the first quarter of this year and this trend may continue in the second quarter as well. This may be explained by the improving labour market situation and by the increase in real wages as a result of low inflation, as well as by the upswing in retail sales volumes. In June, according to preliminary data, sales volumes increased by 6.4 per cent year on year, while the increase in turnover was 0.7 per cent compared to the previous month. In June, turnover may have increased in a wide range of products. In accordance with the material fall in fuel prices, observed in the recent period, the growth in fuel sales continued to have a material contribution to the growth in retail sales volume. Domestic sales increased at a higher rate than the average observed in the countries of the region and in the developed European countries.

The baseline projection of June indicated the continuation of a structurally balanced economic growth.In addition to a further increase in consumption and investments, net exports may also significantly contribute to the expansion in the economy. 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 falling oil prices may boost growth in EU Member States, the protracted Russia-Ukraine crisis and the deteriorating growth outlook in Russia and Ukraine may decelerate it.

1.2.2. Employment

According to Labour Force Survey data, **in the second quarter of 2015 the number of employees in the whole economy increased by 3.1 per cent year on year**. The previous quarter's rise in activity continued, the **number of unemployed continued to decline** (Chart 6), as a result of which the unemployment rate fell below 7 per cent in the **second** quarter. **Based on the preliminary data, employment in the private sector increased slightly**, while that in the general government rose materially in the second quarter. Within the private sector manufacturing employment stagnated, while employment in the services sector increased.

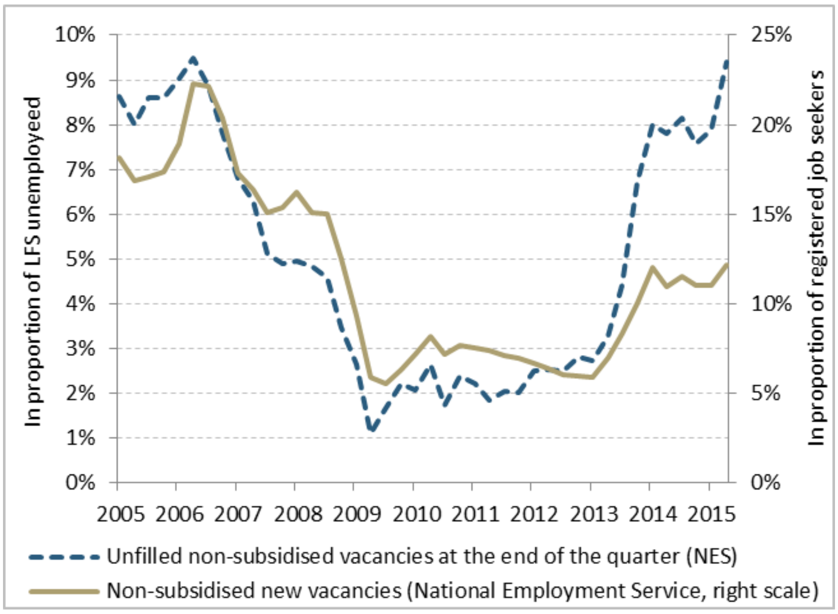
Chart 6: Number of employed persons and unemployment rate



Source: HCSO

In the second quarter, the number of newly announced non-subsidised jobs declined slightly, while the number of vacant, non-subsidised jobs increased considerably quarter on quarter. The **labour market continues to be 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

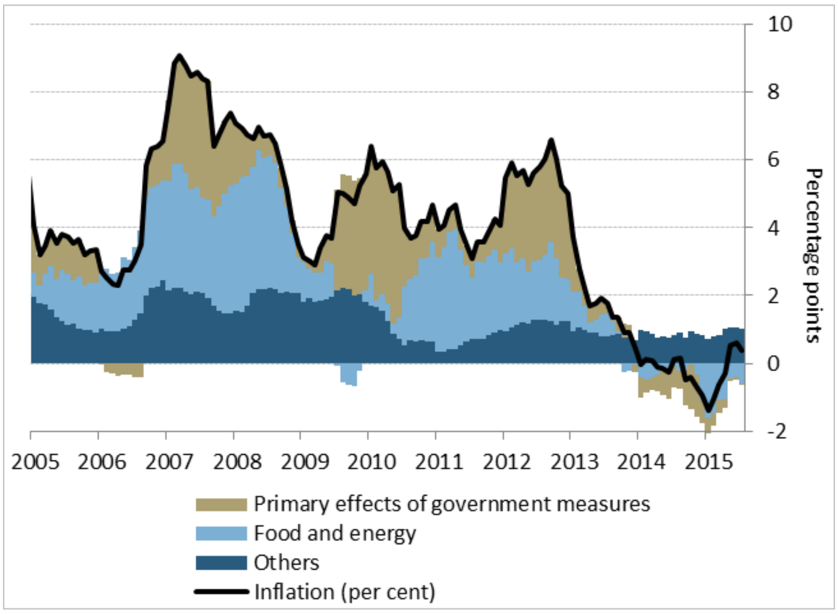
1.3.1. Wages

In May, following the acceleration seen in the previous month, wage index in the private sector decelerated; **the gross average wage in the private sector rose by 2.9 per cent year on year.** Wage dynamics in the manufacturing sector slowed compared to the previous month, while wage index of the services sector stagnated.

1.3.2. Inflation developments

In July 2015, inflation was 0.4 per cent, while core inflation was 1.3 per cent and core inflation excluding indirect taxes stood at 1.1 per cent (Chart 8). The fall in inflation was primarily attributable to the drop in the price index for unprocessed food and fuels.

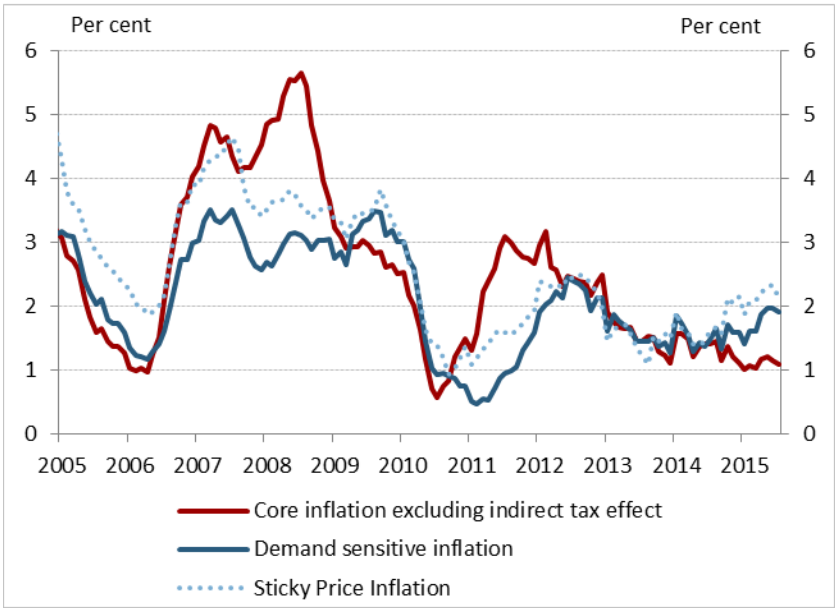
Chart 8: Decomposition of the consumer price index



Source: MNB calculations based on HCSO data.

The underlying inflation measures still signal moderate inflation pressure, attributable to low imported inflation, falling commodity prices and the volume of spare capacities (Chart 9). In June 2015, agricultural producer prices fell by 6.2 per cent in annual terms, while the domestic sales prices of the consumer goods sectors declined by 0.2 per cent year on year. In line with retail trade data, consumption demand may have continued to expand during the second quarter, in parallel with the year-on-year rise in real income.

Chart 9: Measures of underlying inflation



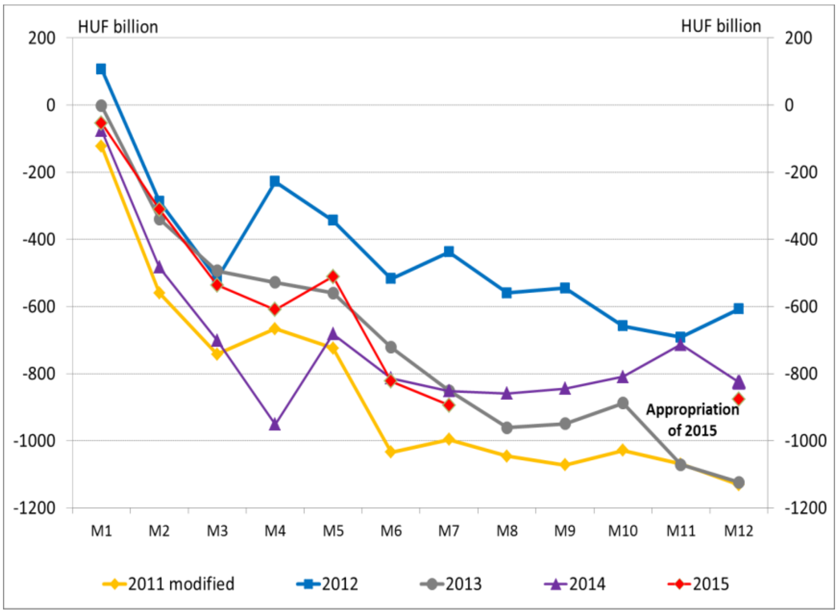
Source: MNB calculations based on HCSO data.

Inflation may remain low in the short term. The data received for July were in line with the projection in the June Inflation Report. Looking ahead, the inflation rate may turn out to be lower than formerly expected, due to the continued fall in oil prices.

1.4. Fiscal developments

In July 2015 the central subsystem of general government registered a deficit of HUF 71 billion, which exceeds the deficit recorded in July last year by HUF 33 billion, and the average of the previous three years by HUF 42 billion (Chart 10). The cumulated deficit of the first seven months was HUF 894 billion, which was slightly higher than the average of the previous two years and also exceeds the annual cash flow plan to a small degree. The revenues of the central subsystem in July 2015 were up by HUF 108 billion year on year, which is mostly attributable to the realisation of higher corporate income tax, excise duty and wage-related revenues compared to the base. Expenditures of the central subsystem in July 2015 exceeded the 2014 base by HUF 141 billion. The increase in expenditures is mostly attributable to the growth in net expenditures of the budgetary institutions related to EU subsidies.

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



Source: Hungarian State Treasury.

1.5. External balance

According to the June data release, the seasonally unadjusted external financing capacity increased close to EUR 1.3 billion, with surpluses of over EUR 800 million and almost EUR 500 million in the current and capital accounts, respectively.

The financing capacity indicated by the financing data also increased and exceeded EUR 1.2 billion. However, in contrast to the previous months, this was achieved under decreasing FDI inflows and a moderate increase in the net external debt, while the gross external debt of the government continued to decrease. In June, similar to real economy data, financing data also signalled a similar degree of financing capacity. However, the structure of this differed from that seen in previous months. The major part of the decrease of EUR 1.7 billion in net direct investments is attributable to the net repayment of loans by the domestic enterprises to their parents, accompanied by the acquisition of Budapest Bank by the state, which also contributed to the fall (EUR 0.6 billion). The net external debt increased slightly, achieved under net finances of the state and the repayment of debts by the private sector. The net finances of the state reflected the fall in foreign exchange reserves (attributable in part to the acquisition of Budapest Bank, and in part to the conversion to forint and the settlement). At the same time, the gross external debt of the state decreased further due to the drop in the government securities holdings of the non-resident sector by around EUR 900 million.

2. FINANCIAL MARKET DEVELOPMENTS

2.1. International financial markets

The period since the last interest rate decision was characterised by volatile financial market sentiment, mostly due to the risks related to China (stock exchange, monetary policy, and growth), unfavourable emerging market developments and uncertainties surrounding the interest rate increase by the Fed. The key stock price indices fell both in Europe and the United States, while exchange rates in the emerging regions (with the exception of the Central and Eastern-European currencies) typically depreciated against the dollar.

Europe still paid special attention to the negotiations with Greece, and finally, in mid-August, the compromise with the creditors on the third bailout package for Greece was agreed, which was approved both by the Parliament of Greece and the finance ministers of the euro area. Although the US economy on the whole is improving, labour market data still show a somewhat inconsistent picture.[1] In accordance with the dual mandate of the Fed, the other component of its target function is the attainment of the 2 per cent inflation target in the long run; however, no considerable progress was made in this area either: both the key inflation indicator and the PCE index, monitored by the Fed, practically stagnated in the recent months. Looking ahead, the fall in oil prices seen in the previous period represents a downside risks to inflation globally. Thus, on the whole, uncertainty concerning the Fed's interest rate path remained: although there are also some signs implying an interest rate increase later, as a result of the favourable macroeconomic figures of the US (e.g. housing market, unemployment), the announcement by the Fed in July and some statements of the policy-makers, market expectations estimate the probability of the interest rate increase by the Fed in September to be around fifty per cent.

Uncertainties related to emerging markets may have been primarily increased by the developments in China (stock exchange volatility, exchange rate policy measures, unfavourable macro data), which were further exacerbated by concerns related to oil exporting countries due to the fall in oil prices and the risks connected with the repayment of the debt of Ukraine. The 8.3 per cent drop in Chinese exports came as a surprise, and the unfavourable purchasing

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[1] On the one hand, it is a positive development that unemployment is low, standing at 5.3 per cent, and the number of those first applying for unemployment benefit also showed a considerable improvement, plunging below 300 thousand; however, the labour force participation rate is at its historic low of several decades. The high number of (mostly involuntary) part-timers is also a problem, while there is no material improvement in the wage dynamics either.

manager index (PMI) and industrial production data further increased the fears related to the deceleration of the Chinese economy. The Chinese stock exchange posted a considerable decline in June, and administrative measures by China managed to halt the fall in stock price indices only temporarily.[2] Investor sentiment related to China were further deteriorated by the IMF's announcement according to which for the time being it would not admit the yuan to the SDR currency basket, explaining this mostly by the fact that the Chinese currency does not yet comply with the criteria of freely usable currency. Presumably this, and unfavourable economic figures, may have also prompted the Chinese central bank to recast its exchange rate policy: while previously the yuan exchange rate could fluctuate in a 2 per cent band compared to the central parity determined daily, as of 11 August the previous day's closing exchange rate is already taken into account in determining the central parity at the start of the day. As a result of this measure, the yuan showed the heaviest depreciation of the previous two decades and implied volatility of the exchange rate increased considerably.

Based on the forecast by IMF, the Ukrainian economy may be hit by even higher than expected recession and inflation, reaching 9 per cent and 50 per cent, respectively, this year. In addition, the negotiations with the creditors seem to be stuck, as Ukraine would like to write off 40 per cent of its debts, while the creditors would accept a rate of 5 per cent. Depending on the result of the negotiations, the next redemption of the foreign currency bond of USD 500 million, due on 23 September, may be at risk, which would result in a disorderly default. Apart from this, Ukraine has a debt of EUR 600 million and another one of USD 3 billion, maturing in mid-October and on 20 December, respectively.

The fall in oil prices, observed in the previous period, is in part due to demand and in part to supply reasons. Once the world price of oil seemed to stabilise in spring, another material fall occurred after the end of June, pushing the price of the Brent and WTI oil down to USD 48.5 and USD 41.6, respectively, which was last seen in the period of January-March. Based on the futures quotes for Brent, only a very moderate increase may be expected in the oil prices in the next two years as well: the oil price per barrel is expected to be around USD 55.3 and USD 60.5 in one year's and two years' time, respectively. On the demand side, concerns with regard to the

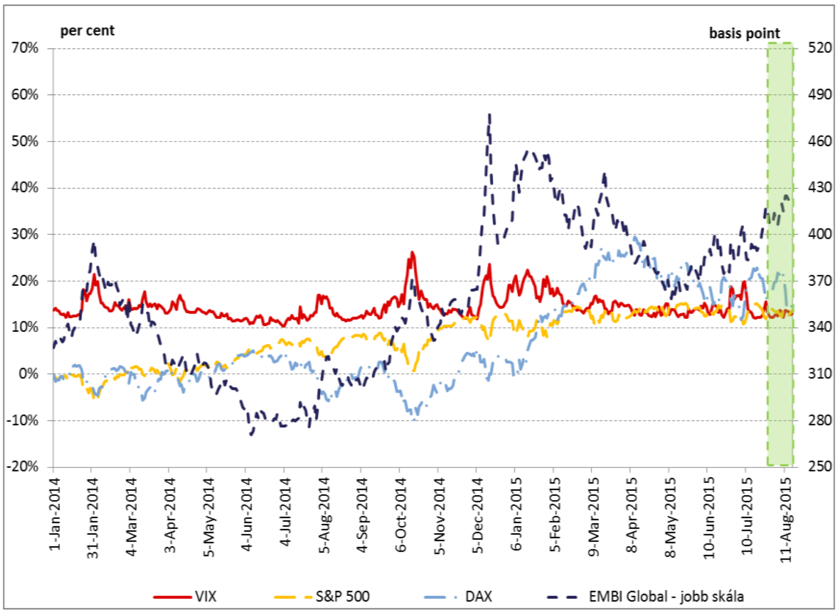
[2] However, at the end of July another contraction wave unfolded, which the Chinese market supervisory authority tried to mitigate by communication tools. In their statement, they confirmed that the measures introduced with the goal to stabilise the stock exchange would remain in force.

deceleration of the Chinese economy and concerns about the global economic activity, while on the supply side the ongoing extraction by the OPEC countries in excess of the quota, the Iran nuclear deal and the more efficient shale oil extraction by the United States contributed and are contributing to the decrease in oil prices, further supported by the strong dollar exchange rate.

Concerns about Greece seem to lessen in recent weeks; capital controls could be partially eased and the Greek stock exchange could also open after several weeks. In July, the ECB provided Greek banks with emergency liquidity assistance (ELA) in an amount that fell short of that of June by about EUR 1.5 billion, mostly due to the increase in new deposits; thus the utilised amount of the EUR 91 billion credit facility fell to EUR 85.3 in July from that of EUR 86.8 billion. All this calmed market sentiment, which was further strengthened by the fact that in mid-August the creditors and Greece managed to agree on the details of the third bailout package. Accordingly, Greece can get the first tranche of the loan of roughly EUR 86 billion from the international organisations, of which it can settle its repayment obligations falling due in the next period and it can recapitalise its large banks. On the other hand, the European creditors are not inclined to start any negotiation with regard to the debt forgiveness before the review of the programme, which is due in autumn.

In parallel with the strengthening in global risk aversion, developed market long-term yields declined. The yield of the 10-year German Bund fell to 0.61 per cent from 0.78 recorded in the beginning of the period. UK and US yields, as well as yields of the periphery countries showed a similar, 15–30 basis points decrease, while the broadly defined emerging market yields typically increased, also reflected in the 35 basis point increase of the EMBI Global bond market index (Chart 11). On the other hand, in the narrower region long-term yields started to fall after a temporary increase, thus by the period-end they fell by 15–30 basis points.

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



Source: Bloomberg.

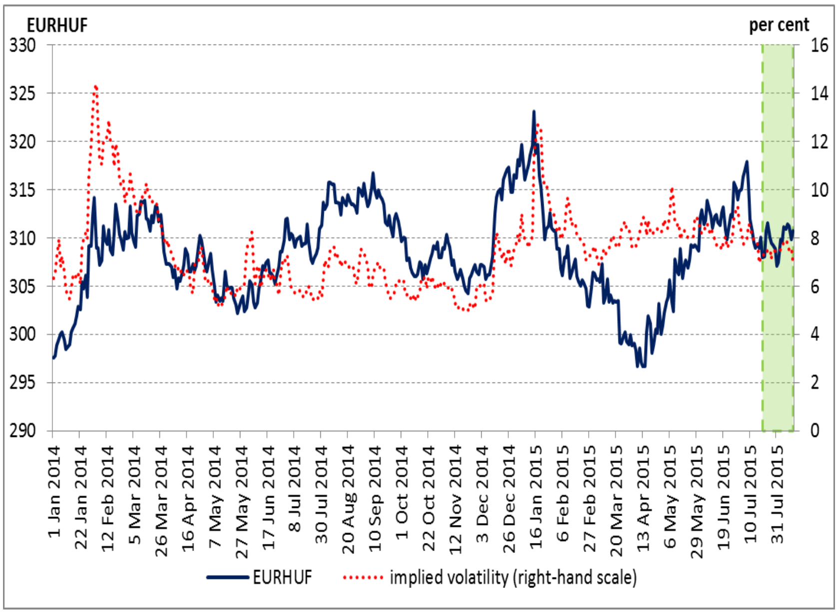
2.2. Developments in domestic money market indicators

Domestic market developments were characterised by the moderate shifts that usually characterise the summer period.

During the period, international news generated only moderate fluctuations in the domestic money market indices, since the negotiations with Greece continued in a relatively calm atmosphere compared to the previous months and there was no material shift in expectations about an interest rate increase in the US. Country-specific news did not have a material impact on domestic market developments during the period. **There was no material change in the Hungarian 5-year CDS spread, and at present it stands around 152 basis points.**

The forint exchange rate against euro fluctuated in a narrow band; the minor fluctuations are attributable to changes in international sentiment. The EUR/HUF exchange rate initially depreciated from the levels of 308 registered at the start of the period, and then it bounced back below the initial level, but at the end of the period the exchange rate once again started to depreciate. On the whole, quotes fluctuated in the band of 307 to 312.5 (Chart 12). In the region, the Czech koruna was steadily around the levels registered in July, showing only minimal appreciation, while Polish zloty lost 0.8 per cent from its value after a gradual depreciation, underperforming the regional currencies. Compared to the zloty, the forint depreciated to a lesser extent during the month, by around 0.3 per cent.

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

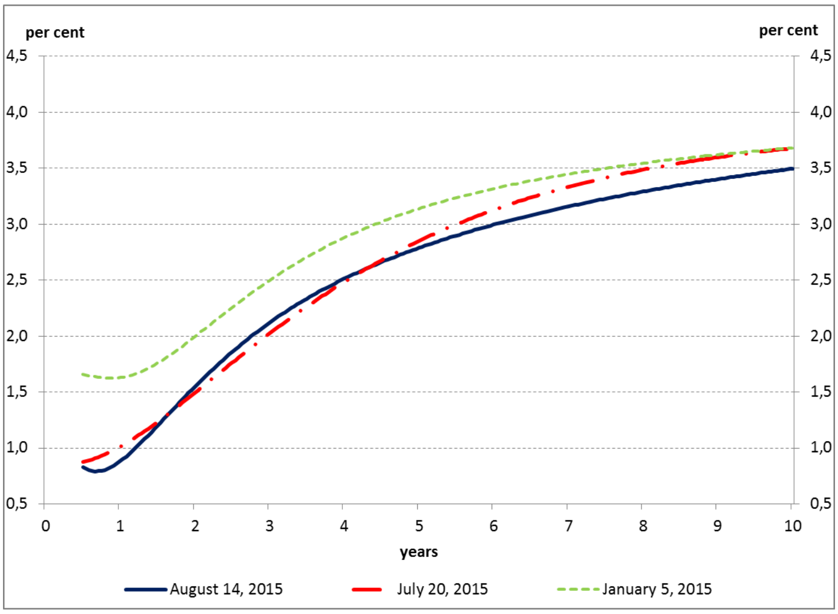


Sources: Bloomberg.

Yields on longer-term Hungarian government securities declined in the period under review. There were mixed shifts in the maturities of up to one year in the secondary market of government securities: there was a minor decrease at the 3-month maturity, while yields at 6-month maturity increased by 4 basis points. By contrast, the 12-month benchmark also fell below 0.9 per cent after a drop of 8 basis points. Long-term yields decreased slightly in the first half of the period under review; however, later on the increase of 3–19 basis points was once again replaced by a decline; thus with the exception of the 3-year benchmark yield, the yields of the long-term securities declined. The 3-month benchmark yield stands at 0.85 per cent, while the 10-year yield once again fell to 3.46 per cent. Short-term yields have fallen gradually in recent months; however, with the end of the easing cycle their fall came to a halt, and yields fluctuated well below the level of the base rate. The fall in long-term yields took place in parallel with movements in yields of the region; the Polish yields decreased somewhat more moderately than the Hungarian 10-year yield, while the Czech and the Romanian 10-year yields could have decreased to a greater degree in the period under review. **The steepness of the Hungarian**

government securities yield curve has decreased since the previous interest rate decision (Chart 13).

Chart 13: Shifts in the spot government bond yield curve



Sources: MNB, Reuters.

Average yields fluctuated at government security auctions during the period. The auctions of 3-month and 12-month securities were characterised by a decrease in average yields, being regularly down by 7 and 9 basis points, respectively. In the past weeks, there was sound demand during the sale of discount Treasury bills, with coverage varying between 1.1 and 2.8. There was also strong demand at the auctions of long-term fixed-rate securities; coverage was more than double on each occasion, and the Government Debt Management Agency regularly increased the issued amount at both auctions of 3, 5 and 10-year securities. Average yields in the fixed rate long-term segments varied; they increased by 20 basis points at 3-year maturities, while they fell by 15 basis point for the 10-year bonds, since the last interest rate decision. In accordance with high demand for 5-year securities, domestic banks showed outstanding interest in the 5-year interest rates swap (IRS) tenders of the MNB. However, the auction of 5-year variable rate securities raised moderate interest.

Non-residents' government securities holdings continued to decrease further, down to HUF 4,265 billion, and then bounced back above 4,300, which in total represents a decrease of HUF 117 billion in holdings. The last time when the government securities holdings of non-residents stood at such a low level was three years ago. This value within the total holding of roughly

13,000 billion, which also includes the variable rate government securities in addition to the discounted treasury bills and the fixed rate bonds, represents a share of 32.5 per cent.

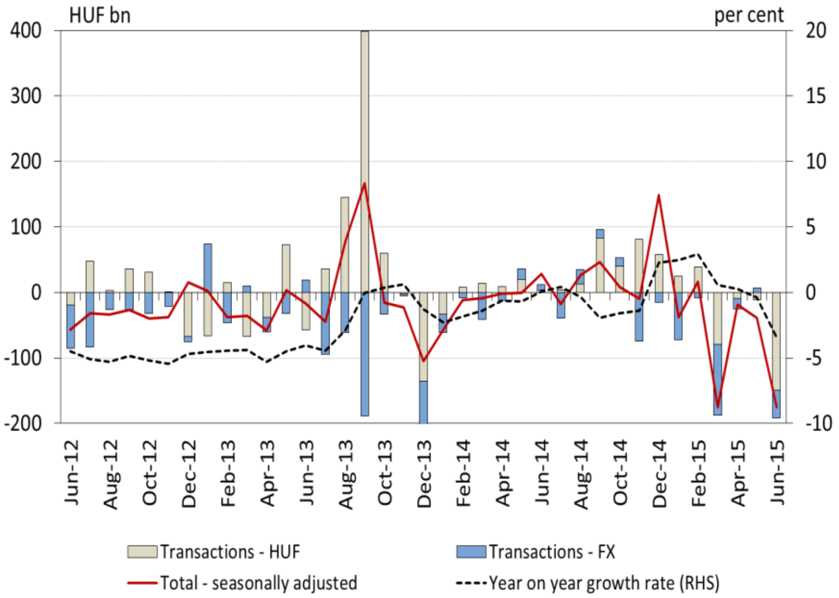
3. BANKING SYSTEM

3.1. Trends in lending

In June, as a result of transactions, the outstanding loans by credit institutions to the corporate sector declined by a total HUF 191 billion (by HUF 175 billion, seasonally adjusted) (Chart 14). Some public corporations made a major contribution to the decline (partly also due to the debt consolidation), accompanied by a large company in foreign ownership, which took its financing abroad from Hungary. In terms of denomination, forint loans and foreign currency loans fell by some HUF 149 billion and HUF 42 billion, respectively. The transaction-based annual growth rate fell from minus 0.4 per cent in May to minus 3.4 per cent. Loans extended under Pillar 1 of FGS contributed around HUF 37 billion to corporate lending in June.

In June, in the case of the newly granted corporate loans, the average interest rate on small-value forint loans decreased further, while the average interest rate on higher-value loans increased by 0.15 per cent.

Chart 14: Net borrowing by non-financial corporations

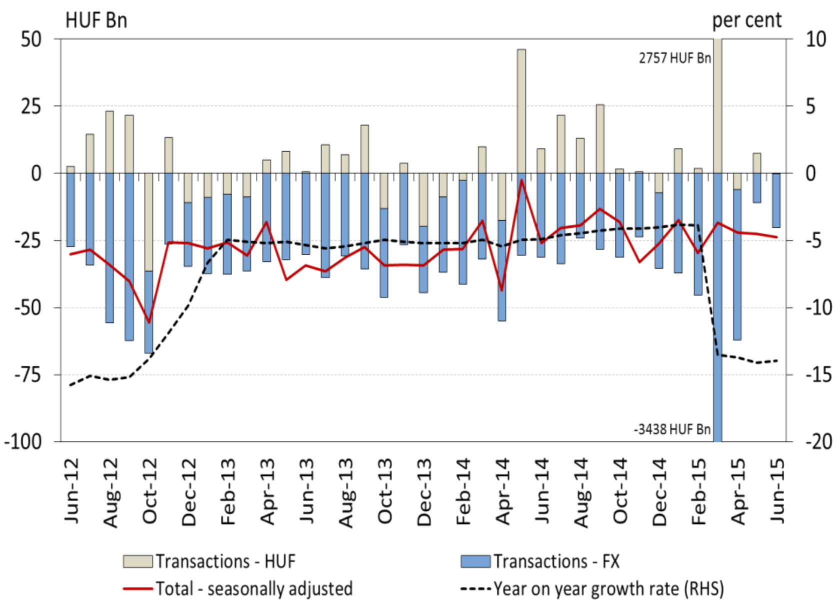


Sources: MNB.

Outstanding loans of the household segment vis-à-vis the credit institutions sector as a whole declined by HUF 20 billion as the result of loan transactions in June (Chart 15). There was no change in the stock of forint loans, thus the decrease was attributable to the change in the foreign currency loans. The annual rate of decline in loans outstanding was around 14 per cent, which is a slight improvement compared to May. The volume of gross new loans lent by the entire sector of credit institutions to households amounted to HUF 64 billion in total, which is consistent with an increase of 24 per cent year on year. New housing loans, general purpose loans, hire purchase loans and vehicle loans granted in June showed an strong increase in annual terms, while the issue of new personal loans practically has not changed; the value of new contracts for other loans fell compared to June 2014.

Interest rates on new housing loans practically did not change in June. The annual percentage rate of charge (APRC) on housing loans exceeded the value registered in May by some 0.05 percentage points. On the other hand, the APRC on general purpose loans continued to decrease, albeit slightly, fell by roughly 0.10 percentage points in June.

Chart 15: Net borrowing by households



Source: MNB.