MACROECONOMIC AND

FINANCIAL MARKET DEVELOPMENTS

BACKGROUND MATERIAL

TO THE ABRIDGED MINUTES OF THE

MONETARY COUNCIL MEETING

OF 30 APRIL 2019

April

2019

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The background material 'Macroeconomic and financial market developments' is based on information available until 25 April 2019.

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

The abridged minutes and the background materials to the minutes are available on the MNB's website at:
http://www.mnb.hu/en/monetary-policy/the-monetary-council/minutes

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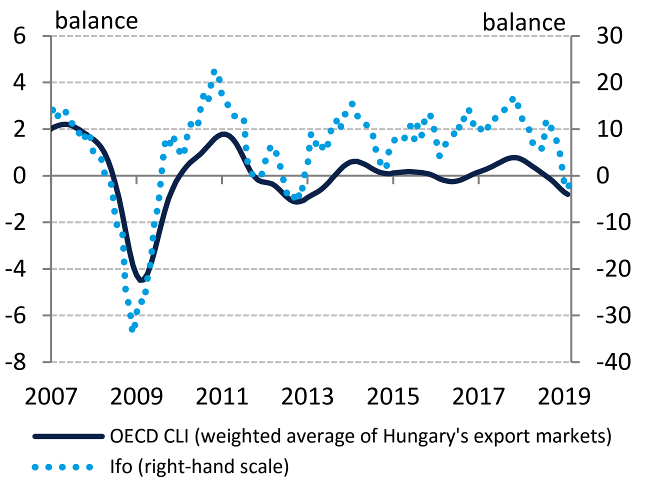
1. Macroeconomic developments

1.1. Global macroeconomic environment

In 2018, growth in GDP of the United States was brisker, while economic growth in the euro area continued at a slower rate. Growth prospects of the euro area substantially deteriorated in the past months. Growth in the CEE region still significantly exceeds that of the euro area.

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



Source: OECD, Ifo

Growth in the global economy continued in the fourth quarter of 2018 at a slower rate than in the previous quarter. In the fourth quarter of 2018, the **US economy increased – at the fastest rate since 2015 – by 3.1 percent in annual terms**, and thus on the whole, the performance of the US economy rose by 2.9 percent in 2018. Household consumption was the key driver of growth, which may have been substantially supported by the tax reform adopted at the end of 2017, which reduced the personal income tax rate. In addition, corporate investments also provided significant support for last year's growth. Net exports made negative contribution to economic performance, which was partially offset by the major inventory accumulation, which preceded the enforcement of the customs measures. The prospects related to the growth of the US economy predict gradual deceleration in parallel with the run-out of the growth supporting fiscal measures (tax cuts and infrastructural investment programme). In addition, the potential deepening of the external trade tensions – due to the major weight of the United States within global imports – may also have substantial impact on global economic growth.

It was a positive surprise that in the first quarter, GDP of China – contrary to the expectations – stagnated at 6.4 percent, while economists expected a deceleration of 0.1 percentage point.

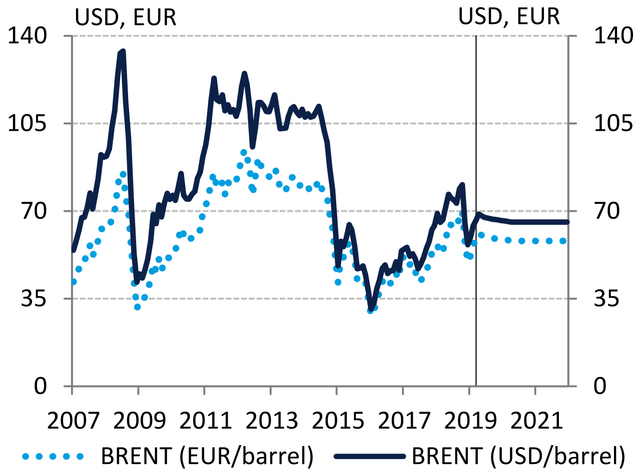
Economic growth in the euro area continued in the fourth quarter of 2018 at a slower rate than observed in the previous quarters. The growth calculated on year-on-year and quarter-on-quarter basis was 1.1 and 0.2 percent, respectively. The economic performance of Germany, Hungary's key trading partner, rose by 1.4 percent in 2018, which was the slowest rate of the past 5 years. The growth of 0.6 percent, registered in the fourth quarter, was primarily supported by investments, while households' consumption was more moderate. Germany's industrial production declined further in February, after the fall registered in January, contributed to by a wide range of subsectors. New orders of the German industry significantly decreased year on year in February as well. In line with the poor industrial performance, German exports also declined quarter on quarter. **Expectations with regard to the German economy's performance this year substantially declined in the past period**, and thus the growth rate is likely to be the lowest one since 2013. The Ifo index, capturing the outlooks of the German economy somewhat adjusted in March, but it is still close to its trough (Chart 1). The impact of the German industrial trends on Hungary's prospects is qualified by the fact that in the past months we witnessed the detachment of the Central-European and German industrial production.

In the fourth quarter, the **French economy** rose by 0.9 percent, contributed to by a wide range of the sectors. **Italy** fell into technical recession (the GDP contracted both in the third and fourth quarters of 2018 on a quarterly basis) which has been unprecedented since early 2013. The economic growth of **Austria** – based on a wide range of sectors – continued, and at 2.1 percent it outstripped the GDP growth of the euro area. The economic performance of the **United Kingdom** rose by 1.3 percent last year, at the slowest rate since 2009. The economic growth was mostly supported by household consumption. Corporate investments stagnated on the whole compared to the previous year, which was also attributable to the uncertainty surrounding the exit from the EU.

As in the previous quarters, the Central and Eastern European region proved to be the growth centre of the European Union in the fourth quarter of 2018 as well. According to the seasonally adjusted data, in the fourth quarter Poland recorded a GDP growth of 4.6 percent, Slovakia and Romania 4.0 percent, while the Czech Republic 2.8 percent. As regards the region as a whole, domestic demand acted as the main driver of growth, while under weakening external activity net exports decelerated growth in several countries at the end of 2018.

Growth prospects of the euro area continue to be dominated by downside risks. Identifiable downside risks affecting European growth include the deteriorating industrial production observed in the past period, the vulnerability of Italy stemming from the high government debt, the potential deceleration of the Chinese economy and the uncertainty resulting from the fragile financial environment on the emerging markets. In addition to the foregoing, the exit of the United Kingdom from the EU also represents risk. At the same time, the deterioration of the outlooks is somewhat mitigated by the fact that the probability of a no-deal Brexit – regarded as the worst scenario for euro area growth – has declined, as the decision-makers of the European Union prolonged the deadline for Brexit until 31 October. As regards the global economic activity, the increase in trade tensions remained the most significant money market and growth risk in the past months.

Chart 2: World market prices of Brent crude oil



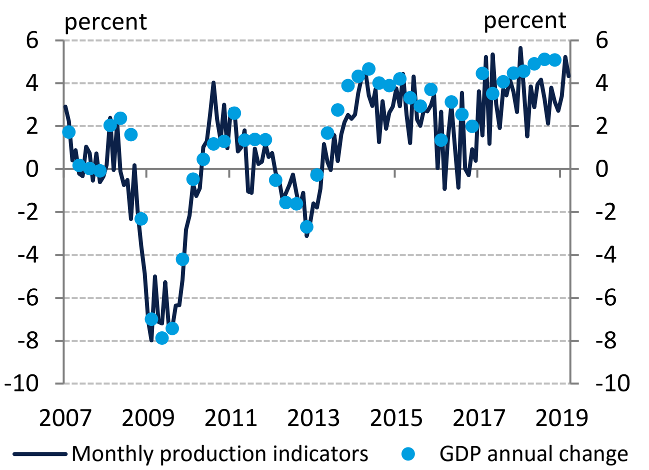
Source: Bloomberg

Underlying inflation measured in the euro area declined further in March, caused by the decelerating rise in service prices and industrial goods. Accordingly, inflation decreased to 1.4 percent and core inflation to 0.8 percent. At the beginning of April, the world market price of oil rose above USD 70, and at present it is around USD 72 (Chart 2). At the beginning of the month the price rise was attributable to the fact that the US labour market data dissipated fears related to the decline in world demand, while in the case of the output of Venezuela the US sanctions and the power cuts deteriorated production outlooks. In addition, the civil unrest in Libya also pointed to an upward drift in prices. At the same time, further growth in oil prices was curbed by the record level of forecasts related to the US shale oil output. On the other hand, there were also rumours with regard to the OPEC+ countries that in order to avoid losing their market share to the USA after all they would not cut oil extraction to the planned degree. World market prices of industrial commodities remained essentially unchanged, while those of unprocessed food declined in March.

1.2. Domestic real economy developments

According to the HCSO's data, in the fourth quarter of 2018, Hungary's gross domestic product rose by 5.1 percent year on year. Buoyant domestic demand continued to support growth. In the period from December 2018 to February 2019, in parallel with the rise in labour force participation rate and employment, the seasonally adjusted unemployment rate fell to 3.5 percent. The labour market tightness indicator calculated from the ratio of job vacancies and unemployed persons remained at a high level.

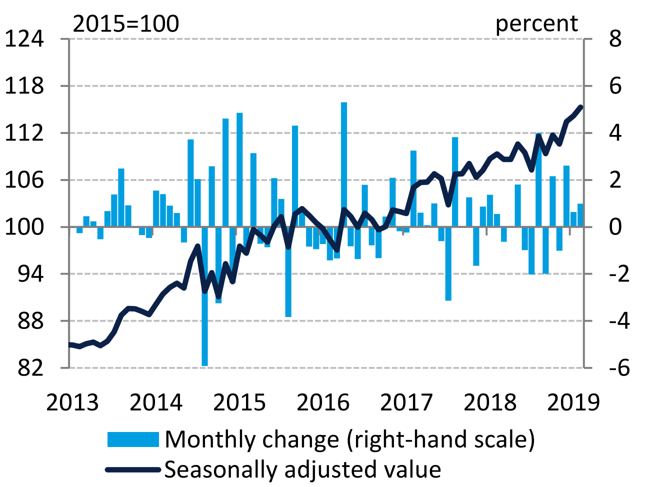
Chart 3: Monthly production indicators and GDP growth



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

Source: MNB calculation based on HCSO data

Chart 4: Development in industrial production



Source: MNB calculation based on HCSO data

1.2.1 Economic growth

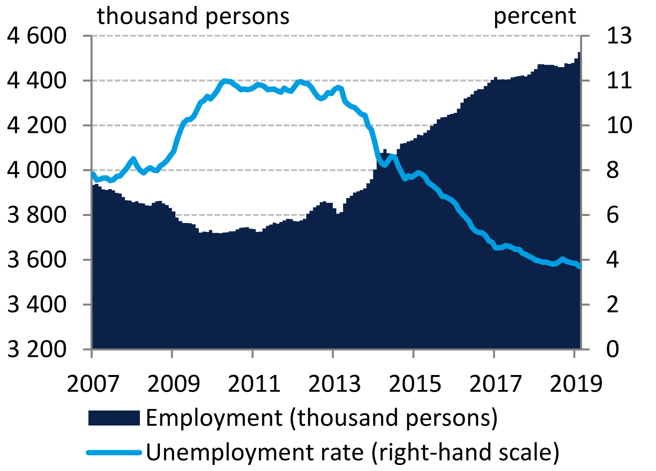
According to HCSO's data release, in the fourth quarter of 2018, Hungary's gross domestic product rose by 5.1 percent year on year. Based on the seasonally and working-day adjusted data, Hungary's GDP rose by 1.0 percent quarter on quarter. From the output side, most of the national economy branches contributed to the growth, and market services supported GDP growth to the largest degree (Chart 3). From the expenditure side, economic growth was supported to the greatest degree by the dynamic rise in internal demand factors, i.e. consumption and investment, while net exports decelerated economic growth in the last quarter. Vigorous growth in GDP may continue in the first quarter of 2019 as well, also evidenced by the available monthly production indicators.

In February 2019, industrial output was up by 5.9 percent year on year, while production rose by 1.0 percent compared to the previous month (Chart 4). On the whole, the output of subsectors showed a positive picture; similarly to the previous month, **the output of vehicle manufacturing – representing a considerable weight – rose again**; in addition, the manufacture of electric equipments, as well as the food industry provided substantial support for the buoyant growth in industrial production.

Expressed in euro terms, **the value of exports** – in parallel with the industrial production – **was up by 6.9 percent, while that of imports rose by 7.0 percent** year on year in February 2019. Trade surplus rose by EUR 49 million. Export and import prices significantly rose in January even in a historical comparison. In January 2019, the terms of trade deteriorated by 1.0 percent, caused by the rise in the relative price of mineral fuels and chemical goods.

In February 2019, the volume of construction output was up by 48.0 percent year on year, while output increased by 6.7 percent compared to the previous month. Output increased both in the case of buildings and other structures. In the case of the construction of buildings, the growth in production was attributable to industrial, office and residential buildings. Due to the government investments, primarily to infrastructure developments (road, railway), construction of other buildings continued to rise. The **volume of new contracts substantially increased** year on

Chart 5: Number of persons employed and the unemployment rate



Source: HCSO

year; within that, the number of contracts for buildings significantly increased, while it decreased in the case of other structures. The month-end volume of construction companies' contract portfolio substantially rose for buildings, while it decreased for other structures.

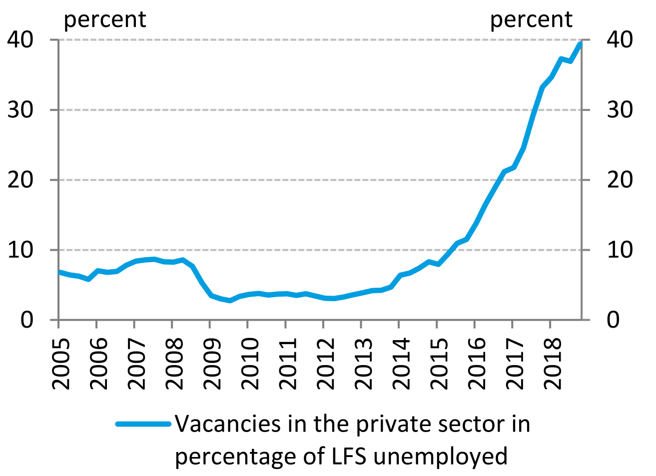
In February, retail sales volume was up by 8.4 percent year on year, based on both the seasonally unadjusted data and the data adjusted for the calendar effect. Retail sales volume rose by 1 percent compared to the previous month. As regards the structure of retail sales, turnover continued to rise in a wide range of products. The substantial rise in the turnover of non-food consumer durables continued to support growth considerably; in addition, the turnover of shops selling food products also showed a major increase. The volume of fuel sales was outstanding in February.

1.2.2. Employment

In parallel with the rise in labour force participation rate and employment, the unemployment rate fell to 3.5 percent (Chart 5). According to the (seasonally adjusted) data of the Labour Force Survey, between December 2018 and February 2019, both the labour force participation rate and the number of people in employment rose. Within total employment, public employment slightly decreased further, while the number of people employed abroad did not change significantly, and thus the rise was realised on the primary labour market.

In the fourth quarter of 2018, based on the number of job vacancies, corporate labour demand remained high in manufacturing, while it moderately rose in the market services sector. The **tightness indicator** calculated from the ratio of job vacancies and unemployed persons **remained at a high level** (Chart 6).

Chart 6: Development of labour market tightness indicator

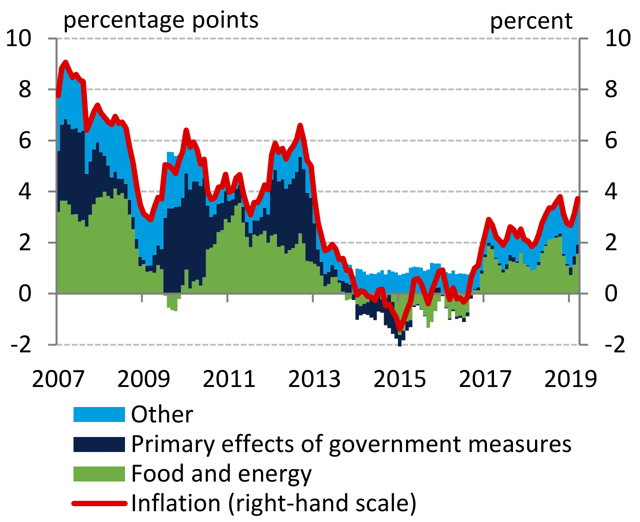


Note: Quarterly data.
Source: National Employment Service, HCSO

1.3. Inflation and wages

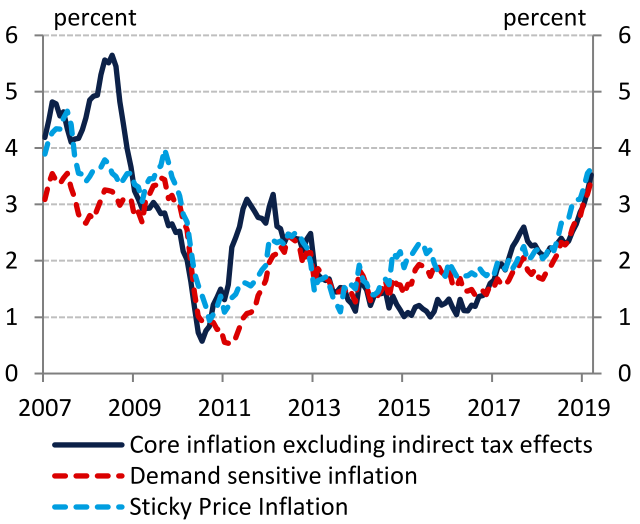
According to the data published by HCSO, in March 2019 year-on-year inflation was 3.7 percent. Core inflation after seasonal adjustment stood at 3.8[1] percent, while core inflation excluding indirect taxes was 3.5 percent. Underlying inflation indicators rose compared to the previous month. In January 2019, gross average wage in the private sector rose by 11.4 percent year on year. The wage dynamics, substantially exceeding the 8 percent rise in the minimum wage and the guaranteed wage minimum, may primarily be attributable to the tight labour market conditions determining the underlying wage setting trend.

Chart 7: Decomposition of inflation



Source: MNB calculation based on HCSO data

Chart 8: Measures of underlying inflation indicators



Source: MNB calculation based on HCSO data

1.3.1. Wage setting

In January 2019, gross average wage in the private sector rose by 11.4 percent year on year. On a monthly basis, the regular average wage rose to a larger degree than the usual seasonality observed in January, by almost 5 percent, which may imply that in addition to the wage increases postponed in December, corporations performed major wage reviews at the beginning of the year. The wage dynamics, exceeding the 8 percent rise in the minimum wage and the guaranteed wage minimum, may primarily be attributable to the tight labour market conditions determining the underlying wage setting trend.

1.3.2. Inflation developments

According to the data published by HCSO, in March 2019 year-on-year inflation was 3.7 percent, while core inflation after seasonal adjustment was 3.8 percent. Core inflation excluding indirect taxes stood at 3.5 percent (Chart 7). Inflation and core inflation rose by 0.6 and 0.3 percentage point, respectively, compared to the previous month. The growth in core inflation was mostly caused by the accelerating increase in the price of industrial goods and the higher inflation resulting from pass-through of the excise duty on tobacco products. In addition, the growth in fuel prices – partly due to base effects – also contributed to the rise in inflation.

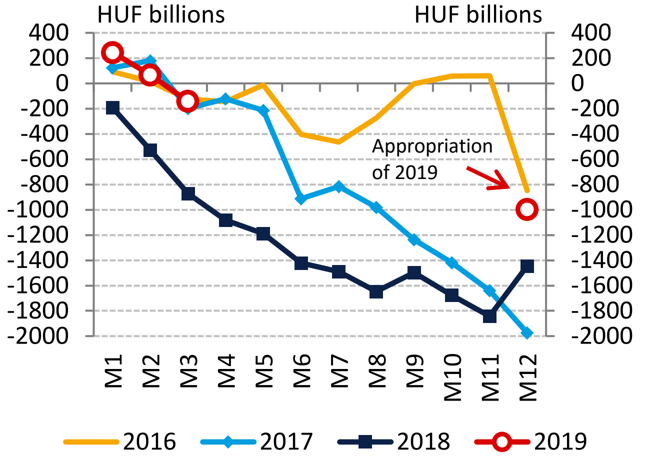
Core inflation excluding indirect taxes rose to 3.5 percent in March. The other underlying inflation indicators capturing the more permanent trends (annual inflation of demand sensitive and sticky price products and services) **also rose** compared to the previous month (Chart 8). In February 2019, agricultural producer prices rose by 7.7 percent in annual terms, while the domestic sales prices of the consumer goods sectors increased by 3.5 percent.

[1] The seasonally unadjusted, raw data is 3.9 percent.

1.4. Fiscal developments

In March 2019, the central sub-sector of the general government closed with a deficit of HUF 209 billion, and thus the deficit accumulated in the first quarter amounted to HUF 142 billion.

Chart 9: Intra-year cumulative cash balance of the central government budget



Source: Budget Act of 2019, Hungarian State Treasury

In March 2019, the central sub-sector of the general government closed with a deficit of HUF 209 billion, and thus the deficit accumulated in the first quarter amounted to HUF 142 billion (Chart 9). The cumulated cash balance recorded at the end of March, which substantially exceeds that of last year, was equally attributable to the revenues exceeding and the expenditures falling short of those of last year.

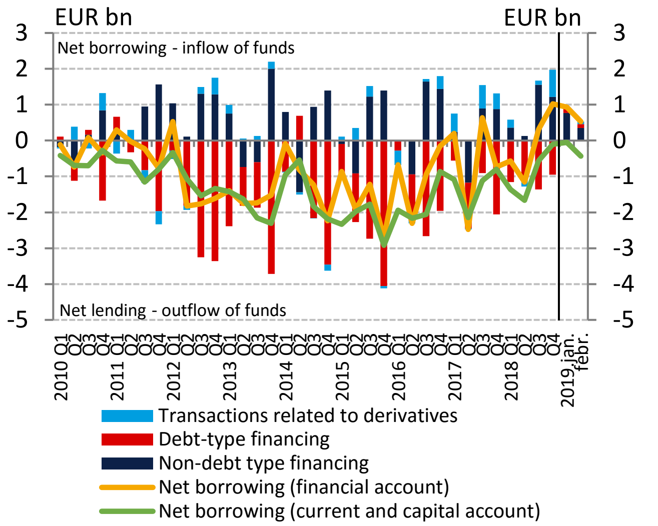
In March 2019, the **revenues of the central sub-sector** were up by HUF 87 billion year on year. This is partly attributable to the higher level of VAT revenues, resulting from the rise in gross revenues. The dynamic growth in incomes related to wages and other earnings also contributed to the higher revenue.

In March 2019, the **expenditures of the central sub-sector** were lower by HUF 49 billion than the value registered last March. Due to the seasonal change in the settlement, the normative and individual subsidies were lower; nevertheless, payments in the first quarter were in line with statutory appropriation.

1.5. External balance developments

In February, the current account of the economy registered a surplus, while net lending also rose. According to the financial account data, in February the rise in net FDI inflow continued, while net external debt moderately rose.

Chart 10: Structure of net lending (unadjusted transactions)



Note: Positive values indicate net borrowing (inflow of funds), while negative values indicate net lending (outflow of funds).
Source: MNB

In February 2019, the current account of the economy registered a surplus of EUR 184 million, while net lending rose to EUR 436 million. The current account – following the deficit recorded in the previous month – turned into surplus, which is primarily attributable to the rise in the balance of goods. The capital account surplus moderately rose under the higher absorption of EU transfers, while the income balance deficit has not changed substantially in February.

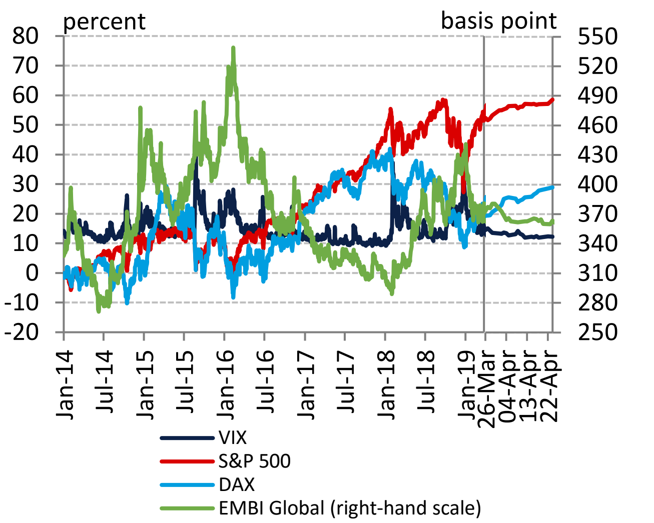
According to the financial account data, the rise in net FDI inflow continued, while net external debt moderately increased. The growth of EUR 280 million in net foreign direct investments was primarily attributable to the reinvested earnings of non-resident enterprises. The moderate increase in net external debt is mostly attributable to the rising foreign liabilities of the banking sector, the impact of which was mitigated by the decrease in the net external debt of corporations (Chart 10).

2. Financial markets

2.1. International financial markets

Since the previous interest rate decision, global market sentiment improved on the whole. This was primarily attributable to the postponement of Brexit and the easing of the trade tensions between the United States and China. Equity indices typically rose substantially in the period under review, and the yields on long-term government securities also increased. Oil prices also rose substantially after the tightening of the US sanctions imposed on Iran.

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



Source: Bloomberg

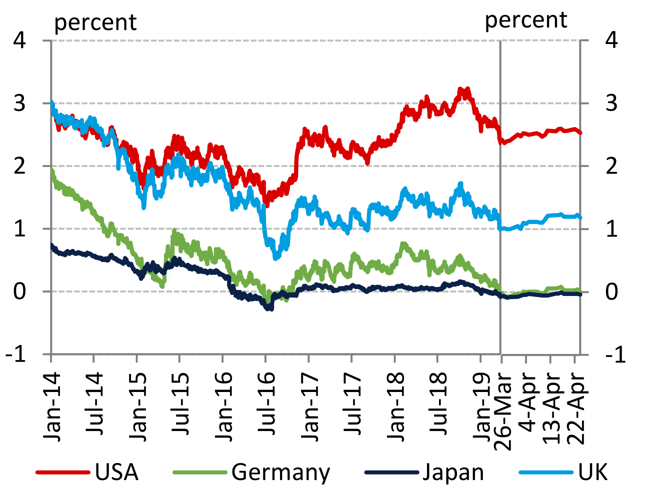
Since the previous interest rate decision, the indices reflecting global investor sentiment slightly improved. During the period under review, the VIX index fell from 15 percent to 12 percent, while global bond market trends also reflected a decline in risk aversion (Chart 11). In parallel with the improvement in global investor sentiment, the MOVE index, measuring the volatility of the USD bond market declined by 7 basis points, while the emerging market EMBI Global spread was down by 14 basis points. The positive developments in market sentiment were primarily determined by the prolongation of the Brexit deadline and the easing of the trade tensions between the United States and China.

The ECB did not modify its monetary conditions at its April meeting. In accordance with the expectations, the ECB did not change the key interest rates, and no additional details were revealed on TLTRO-III, announced in March. At the same time, Mario Draghi acknowledged that they are analysing the possibility of the potential introduction of a multi-tier deposit facility, although he disclosed no details on this either. According to Draghi, incoming economic data continue to be poor, while the anchoring of inflation expectations is not jeopardised. However, based on the market expectations, the date of the first interest rate increase anticipated by the investors was once again postponed: the first interest rate increase is expected to take place in April 2021, while in March the date implied from the market prices was September 2020.

The expectations related to Fed's interest rate policy shifted toward an interest rate cut in December, with 59 percent probability based on the current pricing. At the same time, based on the latest Beige Book, some of the districts reported strengthening economic growth and a rise in housing market sales transaction could be also observed in several districts. In addition, several Fed policy makers emphasised the strengthening of growth in their communication.

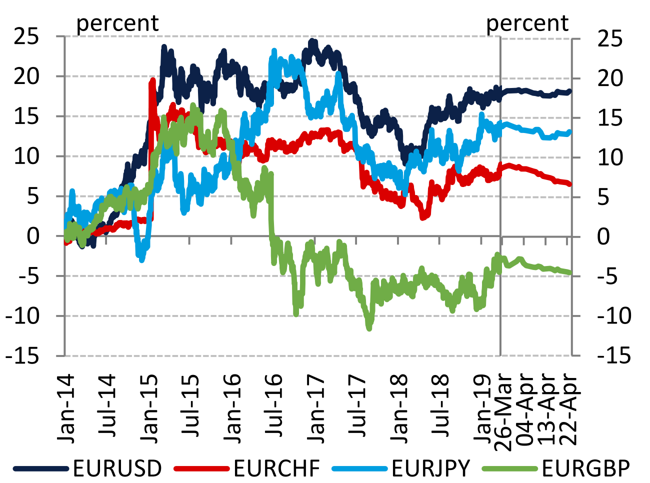
Amid the favourable market sentiment, both the developed stock exchange indices and the emerging market indices recorded a more substantial growth in the

Chart 12: Yields on developed market long-term bonds



Source: Bloomberg

Chart 13: Developed market FX exchange rates



Note: Positive values indicate the strengthening of the variable (second) currency.

Source: Reuters

past period. Of the key stock exchange indices, the US, the European and Japanese indices all rose by 4-8 percent since the previous interest rate decision. Both the MSCI index, representing the developed markets, and the composite MSCI index measuring the performance of the emerging market, rose by roughly 3.5 percent.

Both the developed and emerging market long-term government securities yield typically increased. On the developed markets, the US long-term yield rose by 11 basis points to 2.53 percent, while the German and Japanese yield was up by 1 and 2 basis points, respectively, and thus those still fluctuate close to 0 percent (Chart 12). Emerging market bond markets were also characterised by rising yields; however, the degree thereof was smaller than the US rise, as a result of which the spreads contracted. The trend was also reflected by the 14 basis point decline in EMBI Global, which implies an improvement in the perception of the emerging region.

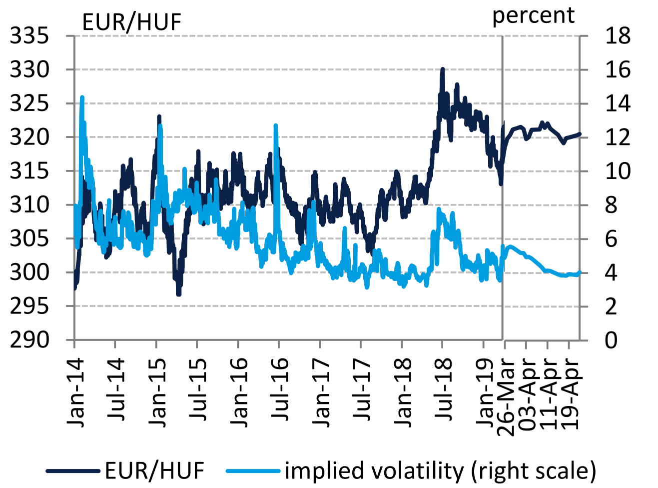
Global foreign exchange markets were characterised by the moderate appreciation of the dollar. Although in the period under review the dollar exchange rate to euro was steadily around 1.12, its exchange rate against the British pound, the Japanese yen and the Swiss franc appreciated by roughly 1-2 percent (Chart 13).

Oil prices, primarily due to the tightening of the US sanctions imposed on Iran, rose during the period under review. The price of WTI and Brent rose by 10 and 9 percent, respectively, since March, while the year-to-date price growth exceeds 35 percent. The rise in oil prices was caused primarily by the tightening of the US sanctions imposed on Iran. From November, the United States introduced sanctions against the countries importing Iranian oil, from which it exempted 8 countries until May. At the same time, contrary to the market expectations, the exemption was not extended, and thus from May the sanctions will affect all importing countries. The declining Venezuelan oil extraction resulting from the power cuts and the larger reduction of Saudi Arabia's production than previously committed to, also pointed to a rise in oil prices during the month.

2.2. Developments in domestic money market indicators

During the period under review, the forint slightly depreciated against the euro. The 3-month BUBOR rose by 3 basis points to 16 basis points. The short section of the government securities market yield curve declined, while the middle and long sections rose.

Chart 14: EUR/HUF exchange rate and the implied volatility of exchange rate expectations

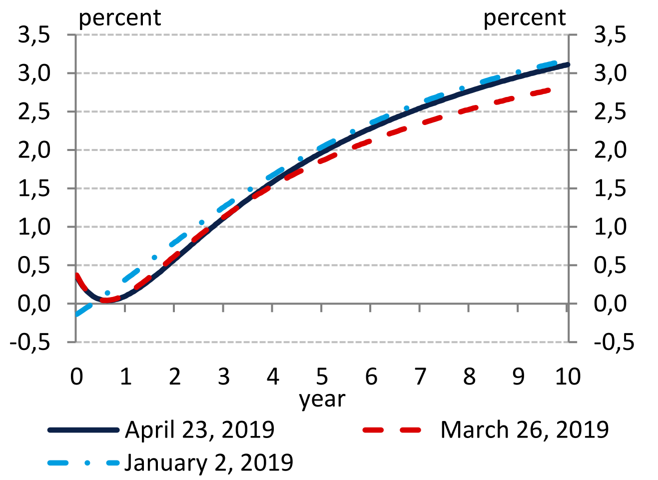


Source: Bloomberg

During the period under review, the forint exchange rate against the euro depreciated by 1.8 percent. By the middle of the period the forint partially adjusted, followed by a repeated depreciation (Chart 14). During the last one month, among the currencies of the region the forint underperformed: on the whole, the Polish zloty and the Czech koruna slightly appreciated against the euro, while the exchange rate of the Romanian leu was essentially unchanged.

The 3-month BUBOR, relevant for the monetary policy transmission, rose by 3 basis points, and thus it stood at 16 percent at the end of the period. The short section of the government yield curve slightly declined, while the middle and long sections – similarly to the interbank yield curve – rose (Chart 15). The short section of the yield curve was characterised by a decline of 2-4 basis points, while the middle and long sections registered a rise of 5-15 and 15-30 basis points, respectively.

Chart 15: Shifts in the spot government yield curve



Source: MNB, Reuters

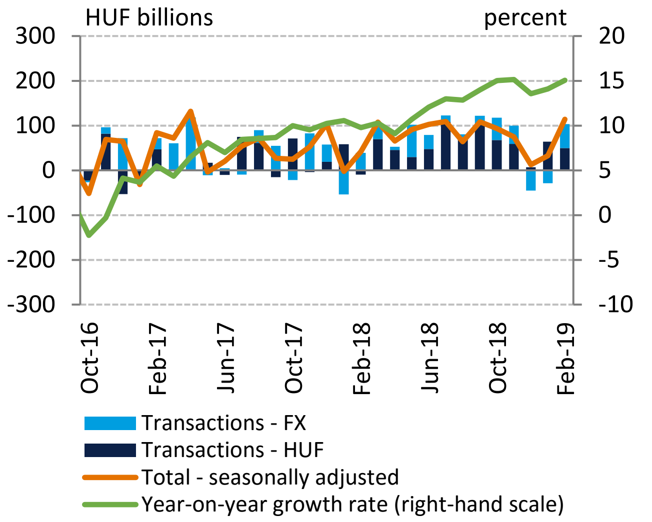
At the forint government bond auctions, under strong demand, the actual issuance often exceeded the announced volume, while at the auctions of the securities with shorter maturity the Government Debt Management Agency accepted the pre-announced volume. The auctions of the 3- and 12-month Treasury bills were typically characterised by twofold demand, but in the case of the 12-month Treasury bill on one occasion the received bids exceeded the announced volume by more than four times. The 3- and 12-month Treasury bills were issued in the announced volume. The average yield of the 3-month auctions was 0 percent during most of the period. At the 12-month Treasury bill auctions, the average auction yield decreased by 17 basis points to 0.2 percent. The auctions of the longer term government securities mostly attracted strong demand, and thus in most of the cases the Government Debt Management Agency accepted higher volumes than previously announced. The average yield of the 3-, 5- and 10-year securities was 1.39, 2.14 and 3.23 percent, respectively, falling short of the previous period's last average auction yields by 23, 15 and 2 basis points, respectively. The average auction yields developed somewhat oppositely to the change observed in the yield curve since the last interest rate decision, as at the time of the last long-term government securities auctions of the previous period the middle section of the government yield curve was still higher than now, while the long section was at the same level as at present.

Non-residents' forint government securities holdings remained essentially unchanged. Accordingly, the portfolio held by non-residents was around HUF 4,230 billion, while their share remained close to 23 percent of the market holding. The Hungarian 5-year CDS spread fell from 91 basis points to 85 percent during the period under review.

3. Trends in lending

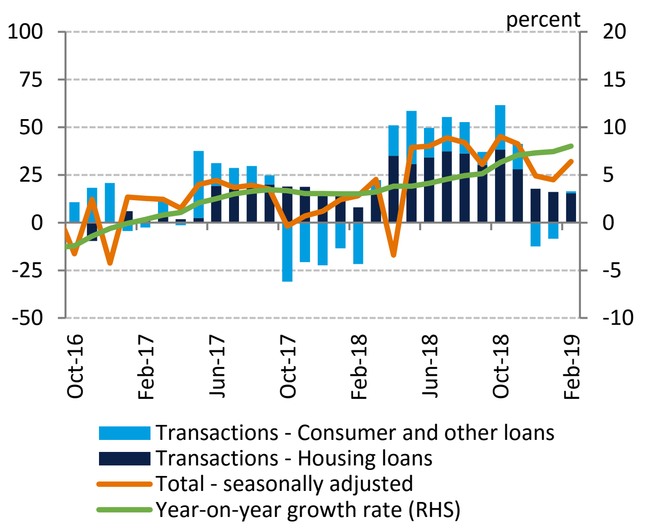
In February, the outstanding corporate loans of credit institutions rose by HUF 104 billion as a result of the transactions. The outstanding loans of the credit institutions to households rose by HUF 16 billion, and thus they registered a 8 percent year-on-year growth.

Chart 16: Net borrowing by non-financial corporations



Source: MNB

Chart 17: Net borrowing by households

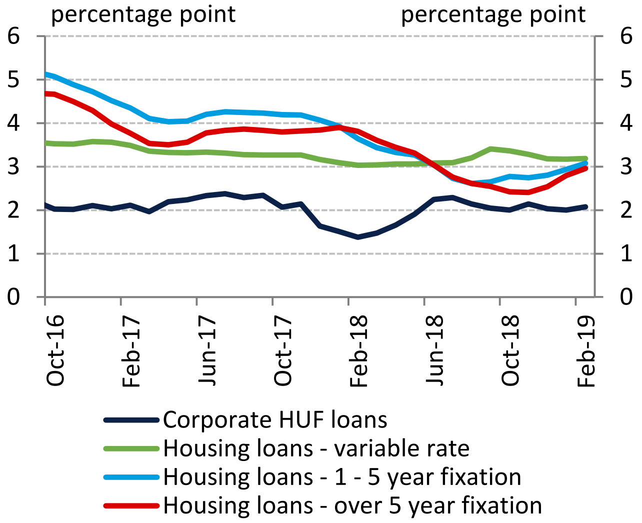


Source: MNB

In February the outstanding corporate loans of credit institutions rose by HUF 104 billion as a result of the transactions (Chart 16). In a breakdown by currency, forint loans and foreign currency loans increased by HUF 50 billion and HUF 54 billion, respectively. The annual growth rate of corporate lending once again exceeded 15 percent in February. Excluding money market transactions, the volume of new loans amounted to HUF 189 billion during the month.

The outstanding loans of the credit institutions to households rose by HUF 16 billion as result of transactions, and thus they registered a 8 percent year-on-year growth (Chart 17). The value of new contracts concluded during the month amounted to HUF 127 billion. New loans were still dominated by housing loans (HUF 61 billion) and personal loan contracts (HUF 42 billion). The Certified Consumer-friendly Housing Loan products make a substantial contribution to the growth in lending for housing purposes in a sounder structure; by February, the ratio of loans with interest rate fixed for more than 1 year rose to 97 percent, while of those fixed for 5 years rose to 70 percent.

Chart 18: Development of corporate and household credit spreads



Note: In the case of corporate forint loans, the spread over the 3-month BUBOR. In the case of housing loans with variable interest or interest fixed for 1 year at the most, the 3-month BUBOR, while in the case of housing loans fixed for over one year, the APR-based margin above the relevant IRS.
Source: MNB

The smoothed interest rate spread of forint corporate loans was 2.1 percentage points in February 2019 (Chart 18). The average smoothed interest rate spread on variable rate housing loans calculated on the basis of the annual percentage rate (APR) dropped by 8 basis points compared to September 2017, to 3.2 percentage points. In the case of loans the interest rate of which is fixed for 5 years at the most, this value dropped by 115 basis points to 3.1 percentage points, while in the case of loans fixed for more than 5 years, it fell by 87 basis points to 2.9 percentage points, and thus at present the average spread on fixed-rate loans is already below that on the variable-rate loans.