MACROECONOMIC AND FINANCIAL MARKET DEVELOPMENTS

BACKGROUND MATERIAL

TO THE ABRIDGED MINUTES OF THE

MONETARY COUNCIL MEETING

OF 17 DECEMBER 2019

December

2019

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The background material 'Macroeconomic and financial market developments' is based on information available until 13 December 2019.

Article 3 (1) of the MNB Act (Act CXXXIX of 2013 on the Magyar Nemzeti Bank) defines the achievement and sustainance of 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 deliberate 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

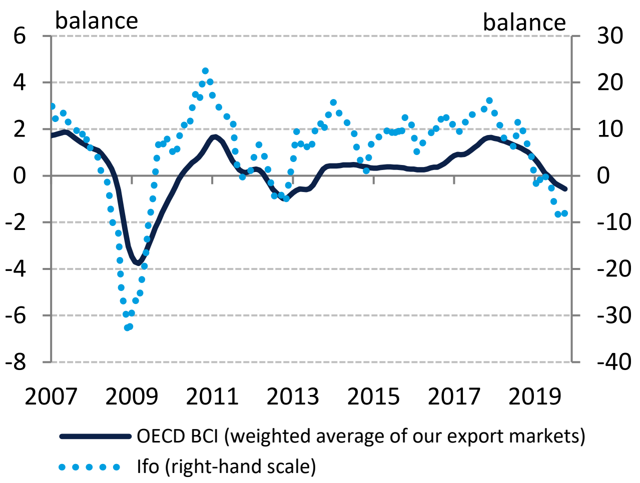
Table of contents

1. Macroeconomic developments

1.1. Global macroeconomic environment

In the third quarter of 2019, the economy of the United States and of the euro area grew at a moderate rate, slightly exceeding expectations. In the euro area former fears of recession eased, nevertheless growth prospects remained persistently restrained. Growth of the CEE region still exceeded the growth rate of the euro area substantially.

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



Source: OECD, Ifo

In the third quarter of 2019, the US economy rose – at a rate exceeding expectations – **by 1.9 percent on an annual basis.** Growth was also supported by household investments, in addition to household and government consumption. Net exports and inventories made negative contribution to the economic performance, and machinery and building-type investments also curbed economic growth. Growth of the US economy may gradually decelerate in the coming period in parallel with the run-out of the growth supporting measures (tax cuts and infrastructural investment programme).

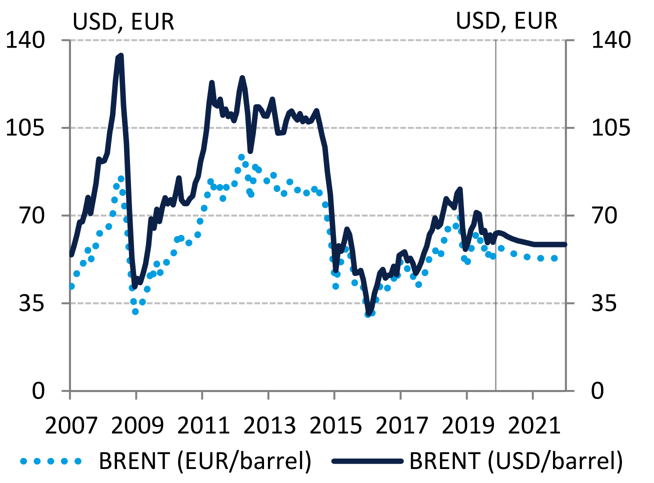
The large economies of the euro area avoided recession, but at the same time, in the third quarter of 2019 economic growth was moderate across Europe. Economic growth of the euro area calculated on year-on-year and quarter-on-quarter basis rose by **1.1** and 0.2 **percent,** respectively. **The economic performance of Germany**, Hungary's key trading partner, **increased by 0.1 percent on a quarterly basis, and thus the German economy avoided technical recession.** The extremely moderate growth was supported primarily by household and government consumption. **Expectations with regard to the German economy's performance this year declined further.** In addition, the forward looking purchasing manager indices for the manufacturing industry still suggest continued unfavourable prospects, but at the same time showed moderate improvement during last month. **The Ifo index, capturing the outlooks of the German economy, is still in the negative range** (Chart 1). New German industrial orders declined further in October on an annual basis. **The fact, that in the past months Hungarian vehicle manufacturing has continued to outperform that of Germany, brings an additional perspective to the short-term impact of the German industrial trends on Hungary's prospects.**

As in the previous quarters, the Central and Eastern European region proved to be the growth centre of the European Union also in the third quarter of 2019. According to the seasonally adjusted data, Poland, Romania, Slovakia and the Czech Republic recorded GDP growth rates of 4.0 percent, 3.2 percent, 1.8 percent and 2.5 percent, respectively. On the whole, the region exceeded the growth of the euro area by almost 2.7 percentage points. Examining the region as a whole, growth is mainly driven by domestic demand, but despite the moderate external activity net exports made positive contribution to growth in several countries.

The deterioration of the business survey indicators in the euro area halted, which, looking forward, may signal a decline in recession risks. At the same time, risks jeopardising economic growth include the increase in trade tensions, the deteriorating industrial production observed in the past period, the challenges surrounding the automotive industry, the vulnerability of Italy stemming from the high government debt, the indirect effects of the deceleration of the Chinese economy and the uncertainty resulting from the fragile financial environment of the emerging markets. In addition, the **uncertainty surrounding the exit of the United Kingdom from the EU** continues to represent material hazard and thus the "fallout" of the United Kingdom from the EU (hard Brexit) remains a realistic scenario.

Based on preliminary data, euro area inflation trends measured in November – slightly exceeding economists' expectations – **rose**, which was also attributable to the base effect of the decrease in fuel prices at the end of last year. **Accordingly, inflation may have been 1.0 percent and core inflation 1.3 percent. In the past period, the world market price of crude oil – showing significant volatility – was around USD 60-65** (Chart 2). World market prices of crude oil was shaped by the combined effect of several factors: the decline in US oil reserves exceeded the expectations, which pointed to a price increase. This was somewhat offset by the fact that the potential date of the agreement between the USA and China became uncertain, since – according to Donald Trump – it may be postponed until after the US presidential elections of 2020. At the Vienna meeting of the **OPEC and OPEC+** countries, held on 5-6 December, **an agreement was reached** on increasing the degree of the present production cut, according to which **from 1 January 2020 the daily production cut will rise by 500,000 barrels per day to 1.7 million barrels** from the level of 1.2 million barrels, in effect since October 2018. For the time being, the production cut will be in force until March 2020 and the decision on its prolongation will be made at the meeting to be held next March. **As a result of the news the oil price increased to above USD 65 per barrel.** The price of industrial commodities decreased, while the world market price of unprocessed food increased in November.

Chart 2: World market prices of Brent crude oil

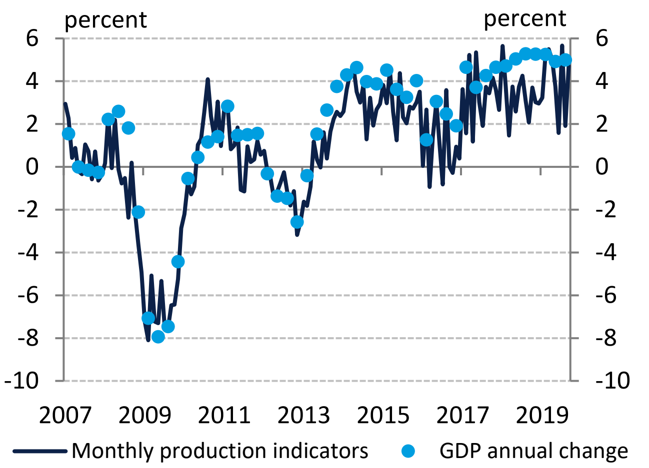


Source: Bloomberg

1.2. Domestic real economy developments

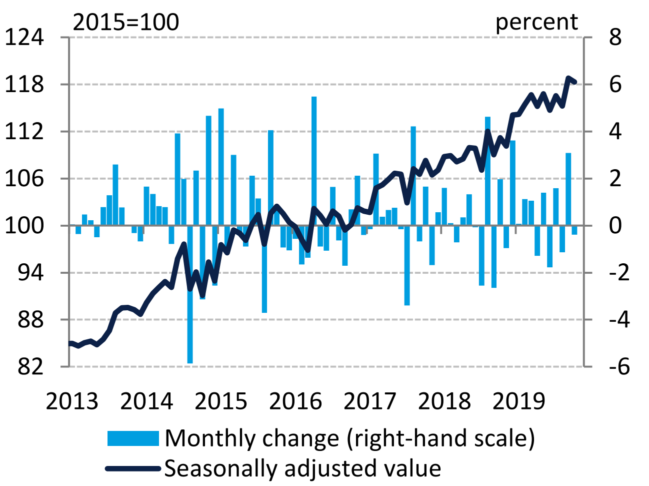
According to the HCSO's data, in the third quarter of 2019, Hungary's gross domestic product rose by 5.0 percent year on year. The seasonally adjusted unemployment rate remained 3.4 percent. In the second quarter of 2019, based on the number of vacancies, corporate labour demand continued to decline in a wide range of the sectors.

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

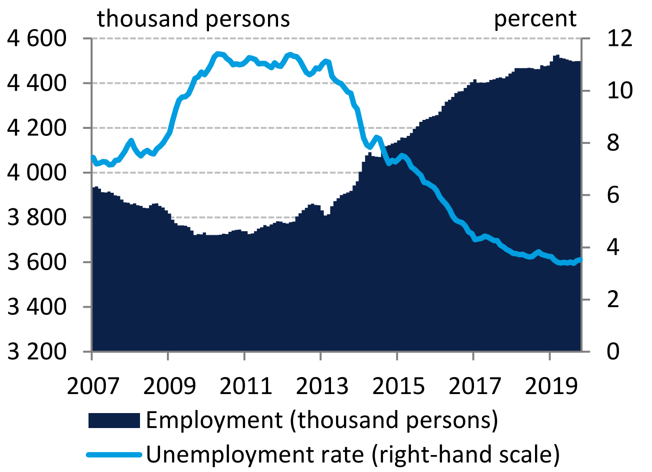
1.2.1 Economic growth

According to HCSO's data release, in the third quarter of 2019, Hungary's gross domestic product rose by 5.0 percent year on year. Based on the seasonally and working-day adjusted data, Hungary's GDP rose by **1.1 percent quarter on quarter. A wide range of the sectors contributed to the growth.** Hungary is ranked first in the EU member states' growth ranking in year-on-year terms. Based on the information provided by the HCSO, **from the output side**, most of the national economy branches contributed to the growth, and **market services, together with industry and construction,** supported GDP growth **to the largest degree** (Chart 3). Despite the ailment of German industrial production, the Hungarian automotive industry materially increased in the third quarter of the year, and thus industry made positive contribution to growth. **From the expenditure side, domestic demand factors** – consumption and investment – continued to increase to a large degree and **supported economic growth,** and net exports also made positive contribution to GDP growth.

In October 2019, **industrial output was up by 6.1 percent** year on year, while production decreased by 0.4 percent compared to the previous month (Chart 4). **The seasonally and working-day adjusted index exceeded that of last year by 6.4 percent.** The output of automotive industry, representing a large weight, increased by 9.6 percent year on year. As regards other sectors, the **manufacture of electric machinery** (21.9 percent) registered material growth. In addition, the rise in **the domestic manufacture of computer, electronics and optical products, pharmaceutical manufacturing and food production** also exceeded the industrial average. In October, the performance of the **metal industry** (-3.4 percent) and the output of the **textile industry** (-8.0 percent) **declined** year on year.

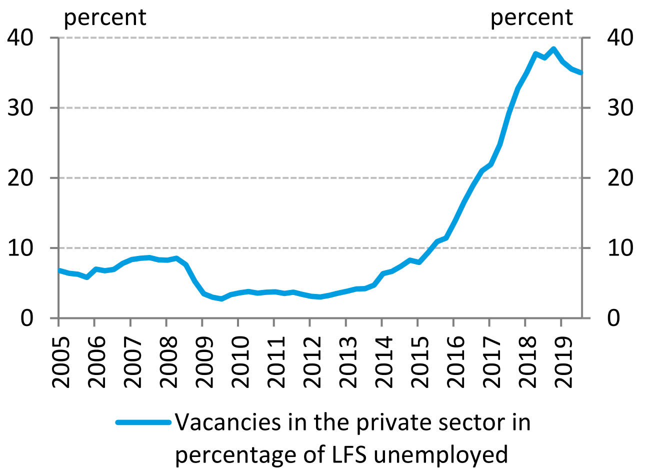
Based on preliminary data, **expressed in euro terms**, **the value of exports and imports was up by 6.7 percent and 3.6 percent,** respectively, in an annual comparison in October 2019, and thus trade surplus rose by EUR 300 million. In September 2019, terms of trade improved further in an annual comparison, which may be attributable to the relative change in the price of mineral fuels, machinery and transport equipment.

Chart 5: Number of persons employed and the unemployment rate



Source: HCSO

Chart 6: Development of labour market tightness indicator



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

In October 2019, the volume of construction output was up by 20.5 percent year on year. Output increased both in the number of buildings and other structures. The growth in the construction of buildings was attributable to the construction of residential, cultural and industrial buildings, while regarding other structures to road and railway development works. **The volume of new contracts increased by 2.7 percent year on year;** the number of contracts for buildings declined by 2.8 percent, while it was up by 8.5 percent for other structures. The month-end volume of the construction companies' contract portfolio fell short of the value registered a year ago by 10.1 percent.

In October, **retail sales volume, based on the data adjusted for the calendar effect, was up by 6.2 percent year on year**. The rise in the total retail sales volume was primarily attributable to the continued growth in the turnover of non-food products (motor vehicles and vehicles parts, industrial goods, mail order shops). **The rise in motor vehicle sales is also contributable to the government's vehicle purchase scheme supporting large families.** Sales of retail chains distributing fast-moving consumer goods increased at a similar rate as in the previous months, which is attributable to the remarkable growth in the food, beverages and tobacco product group.

1.2.2. Employment

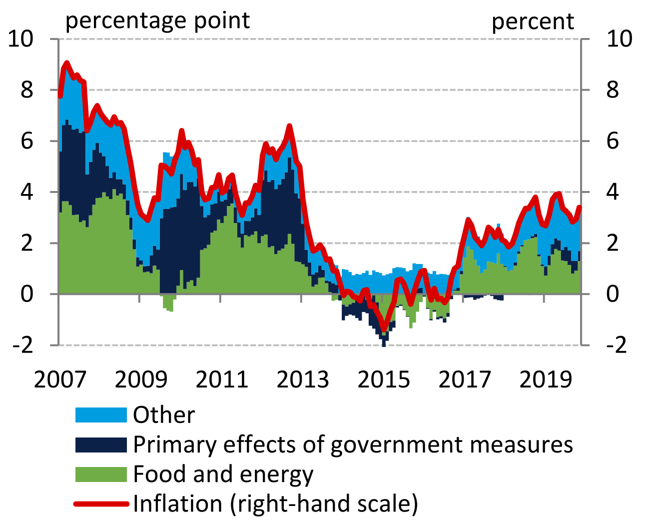
According to the (seasonally adjusted) data of the Labour Force Survey, in the period of August-October 2019, the labour force participation rate slightly increased, while the number of people in employment essentially remained unchanged. The number of people in public employment is 110,000, while the number of people employed abroad remained 118,000. **Seasonally adjusted unemployment rate rose to 3.5 percent** (Chart 5).

In the third quarter of 2019, based on the number of vacancies, **corporate labour demand continued to decline in a wide range of the sectors.** The labour market **tightness indicator** calculated from the ratio of job vacancies and unemployed persons, slackened – similarly to the previous quarter – but **still remained at a high level** (Chart 6).

1.3. Inflation and wages

In November 2019, inflation calculated on year-on-year basis was 3.4 percent. Core inflation stood at 4.0 percent and core inflation excluding indirect taxes at 3.6 percent. The underlying inflation indicators capturing more permanent trends (inflation of demand sensitive and sticky price products and services) remained essentially unchanged compared to the previous month. In September 2019, gross average wage in the private sector rose by 11.6 percent year on year. The wage dynamics, still 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

1.3.1. Wage setting

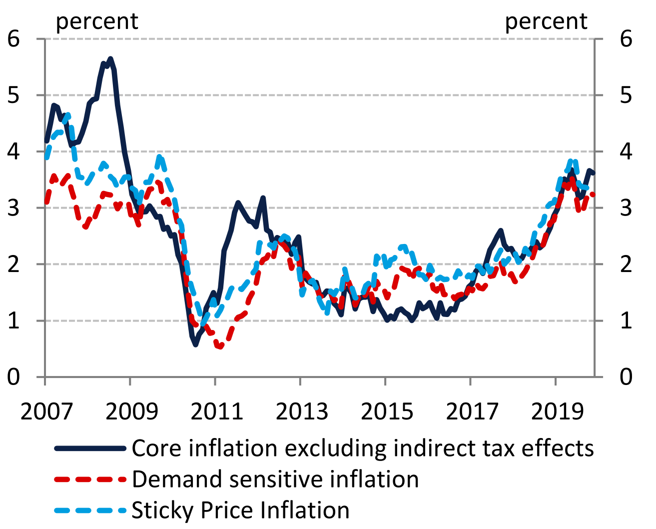
In September 2019, gross average wage in the private sector rose by 11.6 percent year on year. The increase in the regular average wage on a monthly basis slightly fell short of the usual September seasonality, while the bonuses paid by the corporations in September exceeded the level observed in previous years. The regular raise in wages and the bonus trends may have been partly shaped by the reduction of the social contribution tax rate by 2 percentage points as of 1 July. Within the private sector, similarly to the previous months, wage dynamics in manufacturing substantially exceeded the wage growth of the market services sector. The wage dynamics, exceeding the 8 percent rise in the minimum wage and the guaranteed wage minimum, may still primarily be attributable to the tight labour market conditions determining the underlying wage setting trend.

1.3.2. Inflation developments

In November 2019, inflation calculated on year-on-year basis was 3.4 percent. Core inflation stood at 4.0 percent and core inflation excluding indirect taxes at 3.6 percent (Chart 7). Inflation increased by 0.5 percentage point, while core inflation remained unchanged compared to the previous month. The rise in inflation is mostly attributable to the base effect of the fall in fuel prices at the end of last year and the increase in food prices.

The **other underlying inflation indicators capturing more permanent trends** (inflation of demand sensitive products and sticky price products and services) **essentially remained unchanged** compared to the previous month (Chart 8). In October 2019, agricultural producer prices increased by 2.3 percent in annual terms, while the domestic sales prices in sectors of consumer goods increased by 6.2 percent.

Chart 8: Measures of underlying inflation indicators

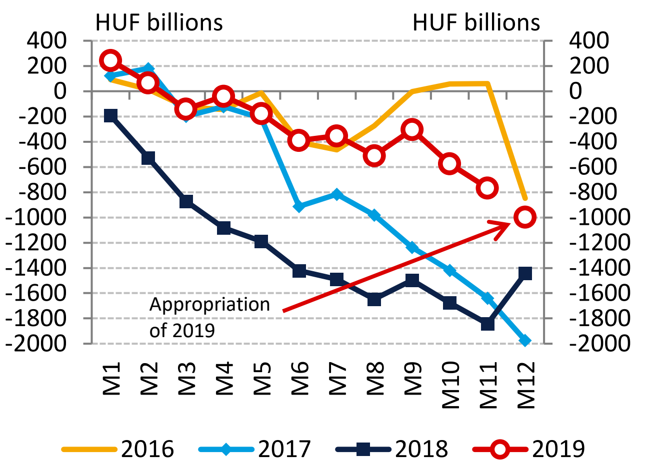


Source: MNB calculation based on HCSO data

1.4. Fiscal developments

In November 2019, the central sub-sector of the general government closed with a deficit of HUF 191 billion, and thus the deficit accumulated in the first 11 months rose to HUF 766 billion. This falls short of the average cumulative cash-based deficit of the central sub-sector registered in November of the previous two years by roughly HUF 1,000 billion.

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



Source: Budget Act of 2019, Hungarian State Treasury

In November 2019, the central sub-sector of the general government closed with a deficit of HUF 191 billion, and thus the deficit accumulated in the first 11 months rose to HUF 766 billion. This falls short of the average cumulative cash-based deficit of the central sub-sector registered in November of the previous two years by roughly HUF 1,000 billion (Chart 9).

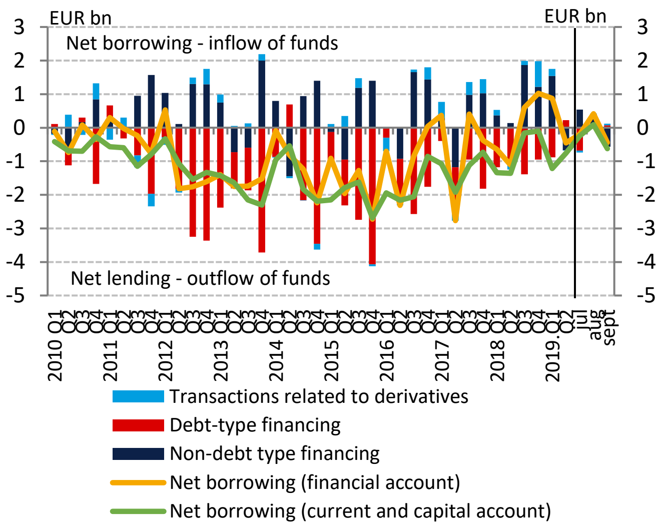
Fiscal revenues were up by HUF 176 billion year on year. The rise in revenues is primarily attributable to a higher realisation of EU funds by HUF 120 billion; in addition, compared to November 2018, the tax and contribution revenues of the central sub-sector rose by roughly HUF 70 billion.

The expenditures of the central sub-sector exceeded those registered in November 2018 **by HUF 202 billion**, which was mostly produced by the higher level of the central organisations' expenditure.

1.5. External balance developments

In September, net lending of the economy amounted to EUR 623 billion, while the current account surplus was EUR 256 billion. The current account turned into a surplus, which is attributable to the rise in trade surplus. The external trade data of October point to further growth.

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 September, net lending of the economy amounted to EUR 623 billion, while the current account surplus was EUR 256 billion. The current account turned into a surplus, which is attributable to the rise in trade surplus, while the transfer balance also increased (Chart 10). The external trade data of October point to further growth.

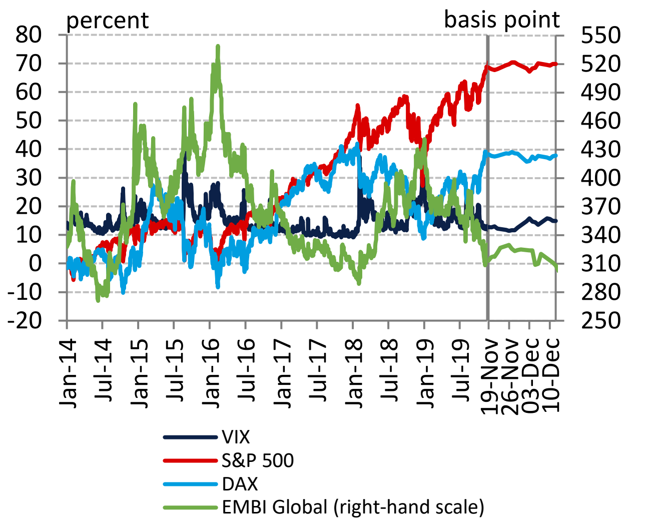
According to the financial account data, foreign direct investments decreased in September, while the net external debt of the economy remained essentially unchanged. According to the financial account data, net lending amounted to roughly EUR 440 million; the outflow of funds can be primarily associated with direct investments, mostly attributable to the domestic agents' outward equity investments. In parallel with this, the stock of debt-type funds did not change materially due to transactions: the decline in the net external debt of the general government was more or less offset by the increasing net external debt of corporations.

2. Financial markets

2.1. International financial markets

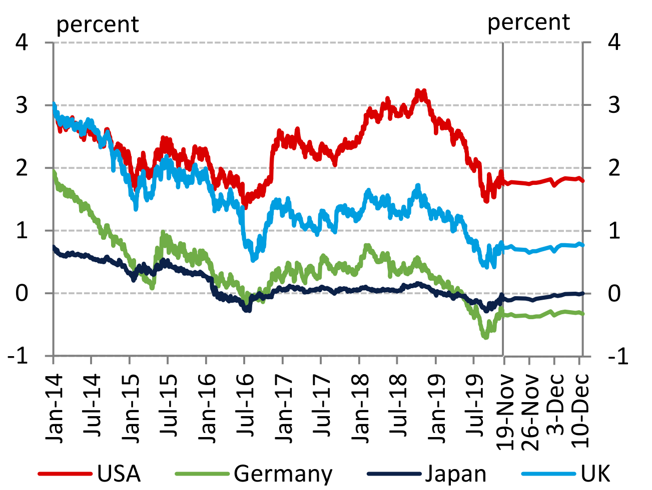
Since the last interest rate decision financial market sentiment did not change substantially. The risk appetite was mostly connected to the expectations related to the trade war and the result of the UK elections. Developed and emerging equity markets remained essentially unchanged, while bond markets were characterised by decreasing yields. Oil prices also rose following the OPEC agreement.

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



Source: Bloomberg

Chart 12: Yields on developed market long-term bonds



Source: Bloomberg

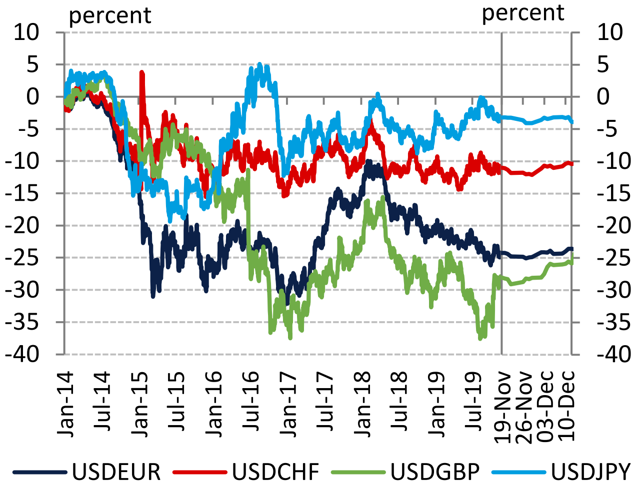
Financial market sentiment moderately improved in the past period. In the past month market participants have been waiting for the new developments related to trade tensions and the outcome of the UK elections held on the 12th of December. Formerly, the Chinese diplomacy made concession to the US (e.g. by purchasing agricultural products), and the US communication also took a tone pointing to an agreement. In the first half of the month both parties hinted at the postponement of the duties to be imposed on USD 160 billion by the American party on the 15th of December. As the date approaches, the outcome of the negotiations is still uncertain, and thus the conclusion of the preliminary trade agreement before the end of the year is also doubtful.

Although the VIX index, the key measure of equity market volatility, increased from 13 to 15 percent, the emerging bond market EMBI Global spread fell by 17 basis points to 300 basis points (Chart 11). **In the past month, the developed stock exchange indices did not change substantially – still standing close to their historic high – while the composite MSCI, measuring the performance of the emerging market, was up by 0.8 percent.** Gold price developed in line with risk appetite during the period under review, and at present it stands close to the level registered one month ago.

Developed market bond yields dropped since the last interest rate decision (Chart 12). The US long-term yield fell by 15 basis points to 1.70 percent, while the German 10-year yield rose by 3 basis points, to -0.32 percent. Emerging market yields varied: the South African ten-year yield rose by 5 basis points, while the Central and East European region was characterised by a yield decrease. Turkish long-term yields fell by an additional 5 basis points compared to the end of the previous period.

Early elections will be held in Great Britain on December 12, the outcome of which will have major bearing on the developments in the Brexit process and the potential closing of the process. According to preliminary estimates, the Conservative Party will win the majority of seats in

Chart 13: Developed market FX exchange rates



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

Source: Reuters

Britain's Parliament, although recently the advantage of the party has gradually decreased.

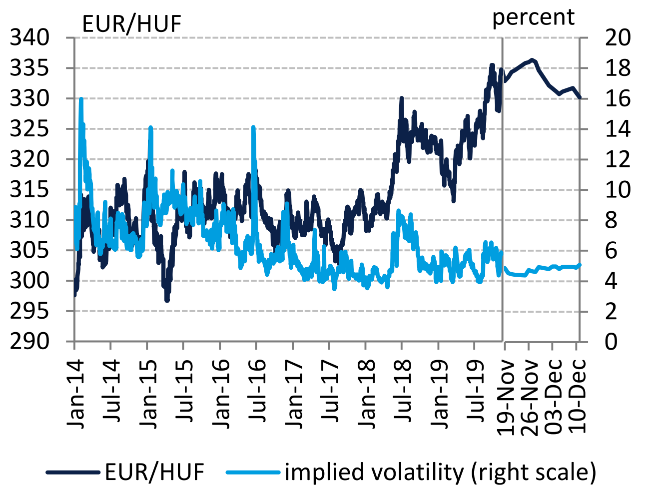
During the period under review, global foreign exchange markets were dominated by the depreciation of the dollar, which was 1 percent against the euro and 2 percent against the pound (Chart 13).

During the last month oil prices rose moderately after the OPEC countries agreed on further production cuts and thus the Brent and WTI quote increased by 3 percent over USD 64 and by 4 percent over USD 59, respectively. Higher increase was curbed by the repeated strengthening of the uncertainties around the trade war. In the past month the Saudi state-run oil company was admitted for listing, which was preceded by heightened market expectations. The transaction had such a great significance for Saudi Arabia that, according to some of the oil market analysts, during the OPEC negotiations it promised production cuts in excess of the preliminary expectations to ensure success. At the same time, oil market analysts are of the opinion that the main question is to what degree the OPEC+ member states will stick to the new agreement.

2.2. Developments in domestic money market indicators

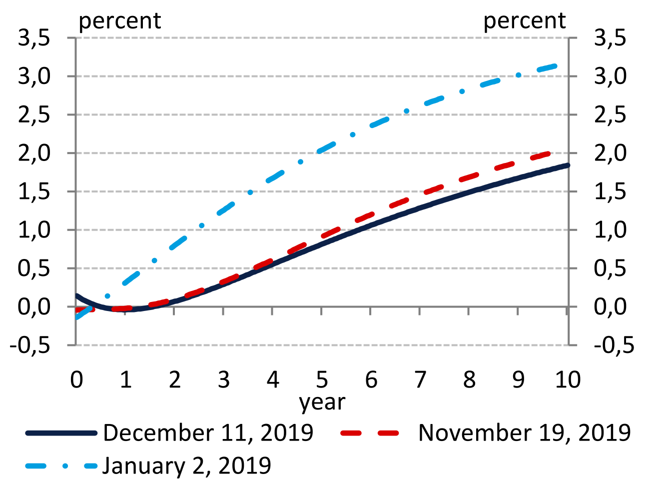
During the period under review, the forint appreciated against the euro under major volatility. The 3-month BUBOR declined slightly (to 0.16 percent). The middle and long section of the government securities yield curve shifted downwards.

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



Source: Bloomberg

Chart 15: Shifts in the spot government yield curve



Source: MNB, Reuters

Since the interest rate decision in November, the forint exchange rate appreciated against the euro, under major volatility, by 1 percent from 333 to 330 (Chart 14). Within the CEE region, the Polish zloty appreciated by 0.3 percent, while the exchange rate of the Czech koruna and Romanian leu did not change substantially.

The 3-month BUBOR, relevant for the monetary policy transmission, declined by 3 basis points since the last interest rate decision, and thus it stood at 16 basis points at the end of the period. **The middle and longer sections of the government yield curve shifted downwards** (Chart 15). The 1-5 year section of the yield curve registered a decrease of 1-10 basis points. On the long section a decrease of 10-22 basis points was observed. The steepness of the yield curve declined during the period under review.

During last month, the discount Treasury bill and government bond auctions were mostly characterised by strong demand, and thus the average auction yields declined on all maturities by the end of the period. The auctions of the 3- and 12-month Treasury bills were characterised by continuously strong demand, but the Government Debt Management Agency issued the announced volume each time. The average auction yield of the 3-month auctions was below -0.05 percent throughout the period. Average yield also declined at the 12-month Treasury bill auctions below -0.05 percent. Demand was also strong at the long-term government securities auctions: from time to time, at the auction of the 3-, 5- and 10-year maturities the Government Debt Management Agency accepted higher volumes than previously announced. The average yield of the 3- and 10-year securities fell by 3 and 1 basis points to 0.32 and 1.92 percent, respectively. The average auction yield of the 5-year government securities first fell by 6 basis points to 1.09 percent, while at the latest auction it rose by 4 basis points to 1.13 percent. The Hungarian 5-year CDS spread fell by 1 basis point during the period under review, and at present it stands at 72 basis points.

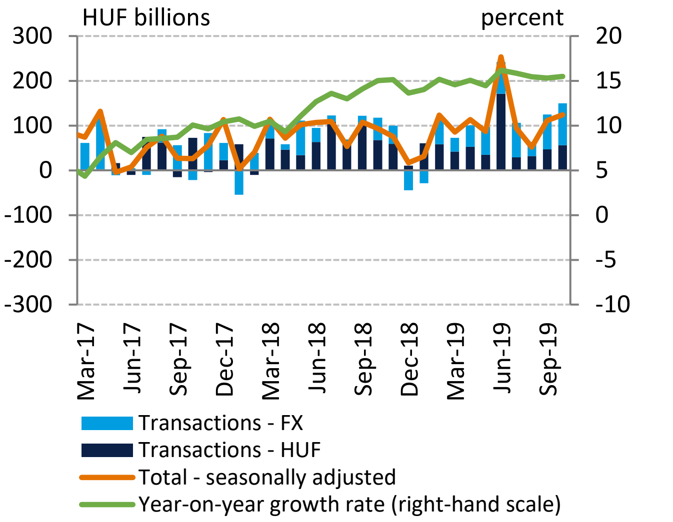
Non-residents' forint government securities holdings decreased. Non-residents’ forint government securities holdings declined by HUF 142 billion to HUF 4,185 billion. Their share within the total portfolio declined by 0.75

percentage point, and thus at the end of the period it was 24 percent of the total outstanding debt.

3. Trends in lending

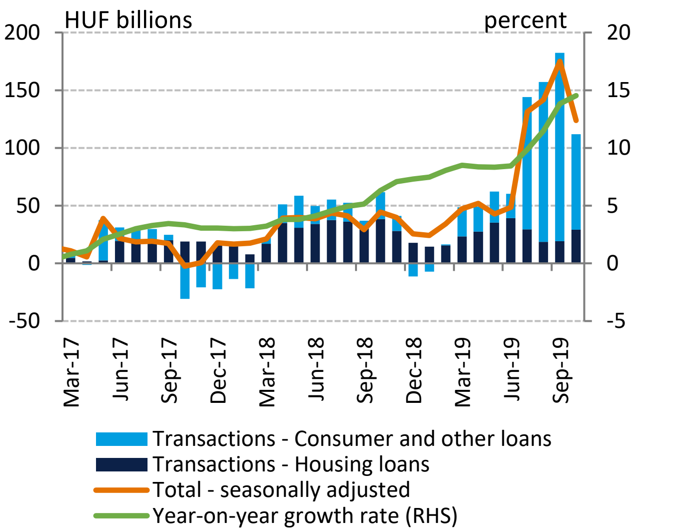
In October 2019, the outstanding borrowing of non-financial enterprises from the credit institution sector increased by HUF 150 billion as a consequence of transactions. Household loans increased materially in October, albeit at a somewhat more moderate rate compared to the previous month, and thus annual growth reached 14.5 percent.

Chart 16: Net borrowing by non-financial corporations



Source: MNB

Chart 17: Net borrowing by households

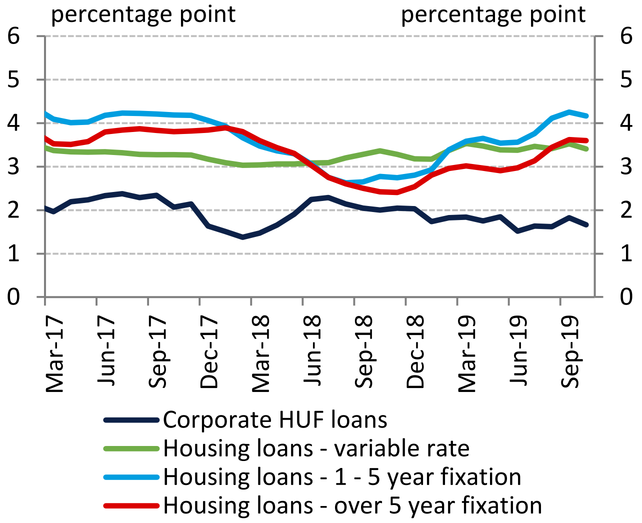


Source: MNB

In October 2019, the outstanding borrowing of non-financial enterprises from the credit institution sector increased by HUF 150 billion as a result of transactions (Chart 16). Last month, forint loans and foreign currency loans increased by HUF 56 billion and HUF 94 billion, respectively. Thus, the value of the corporate loan portfolio increased by almost HUF 1,200 billion, i.e. 15.5 percent during the last one year. The growth in outstanding borrowing still rests upon a broad base in respect of both banks and industries.

Household loans increased materially in October, albeit at a somewhat more moderate rate compared to the previous month. Thus, the annual growth rate reached 14.5 percent (Chart 17). The value of new contracts increased by 42 percent in annual terms. Demand for the prenatal baby support loans, launched in July, was significant in October as well, but for the time being this is not accompanied by materially lower demand on the personal loan or housing loan market, and thus its additional impact may be deemed high.

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 1.67 percent in October 2019, representing a decrease of 0.15 percentage point compared to the previous month (Chart 18). **The average smoothed interest rate spread on variable rate housing loans calculated on the basis of the annual percentage rate (APR) declined during the month** and amounted to 3.41 percentage points. Longer term funding costs (relevant IRS) remained practically unchanged in October compared to the previous month; in addition, the APR level of housing loans also stagnated, or in certain product groups slightly decreased. Accordingly, **the spread on products with an interest rate fixation longer than one year and up to 5 years declined by 0.10 percentage point, while that on products with interest rate fixation for more than 5 years dropped by 0.02 percentage point**. **The average spread on housing loans with an interest rate fixation longer than one year and up to 5 years reached 4.16 percentage points in October, while the spread on products with interest rate fixation for more than 5 years was 3.6 percentage points.**