MACROECONOMIC AND FINANCIAL MARKET DEVELOPMENTS

BACKGROUND MATERIAL

TO THE ABRIDGED MINUTES OF THE

MONETARY COUNCIL MEETING

OF 26 FEBRUARY 2019

February

2019

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The background material 'Macroeconomic and financial market developments' is based on information available until 21 February 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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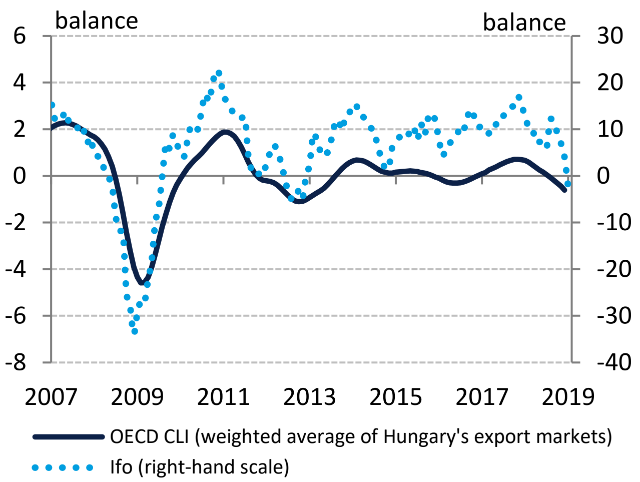
1. Macroeconomic developments

1.1. Global macroeconomic environment

In 2018, the GDP growth of the United States continued at a brisker, while the economic growth in the euro area at a decelerating rate. Growth prospects of the euro area substantially deteriorated in the past months. On the whole, the risks indicative of the deceleration of the global economy strengthened in the past period.

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



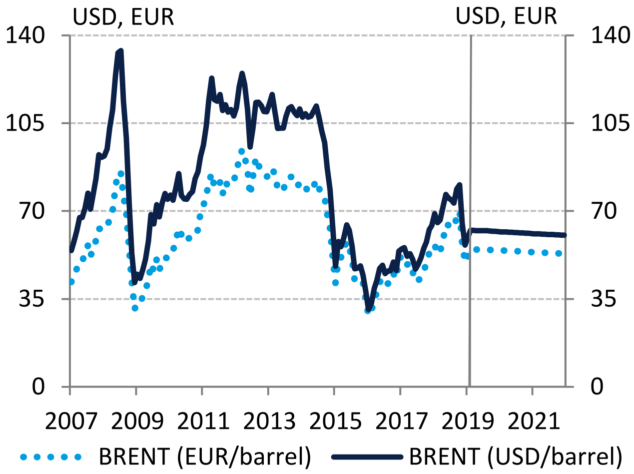
Source: OECD, Ifo

Growth in the global economy continued in the fourth quarter of 2018. For the time being, there are no data about the developments in the GDP of the **United States** in the fourth quarter; however, according to the expectations, growth continued at the end of the year. In 2018, domestic demand was the key driver of economic growth in the United States, where expansion was supported primarily by household consumption. Short-term growth prospects of the US economy are favourable on the whole, contributed to by the tax cuts and the economic stimulus effects of the infrastructural investment programme. However, the run-out of the growth supporting measures represents downside risk on economic performance from 2020. 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 tangible impact on global economic growth.

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 1.2 and 0.2 percent, respectively.** The economic performance of Germany, Hungary's key trading partner, essentially stagnated in the fourth quarter, and thus in annual terms it rose by a total of 1.4 percent last year. The quarter-on-quarter decline observed in the third quarter was followed by a moderate positive adjustment in the last three months of 2018. **Expectations with regard to the German economy's performance this year lessened further** in the past period, which is primarily attributable to the poor industrial production. Germany's industrial production substantially declined in December, contributed to by a wide range of subsectors. In December, new orders of the German industry materially decreased year on year, while the number of new orders of the vehicle industry once again rose. In addition, the Ifo index, capturing the outlooks of the German economy, declined to its lowest level of almost the last three years in December (Chart 1).

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.

Chart 2: World market prices of Brent crude oil



Source: Bloomberg

According to the seasonally adjusted data, in the fourth quarter Poland, Slovakia and the Czech Republic recorded a GDP growth of 4.6 percent, 4.0 percent and 2.9 percent, respectively. Following the outstanding growth registered in 2017, Romania's economic performance decelerated further in the fourth quarter, and thus the Romanian GDP rose by 4.0 percent year on year. Growth in the countries of the region was still supported by the dynamically increasing domestic demand.

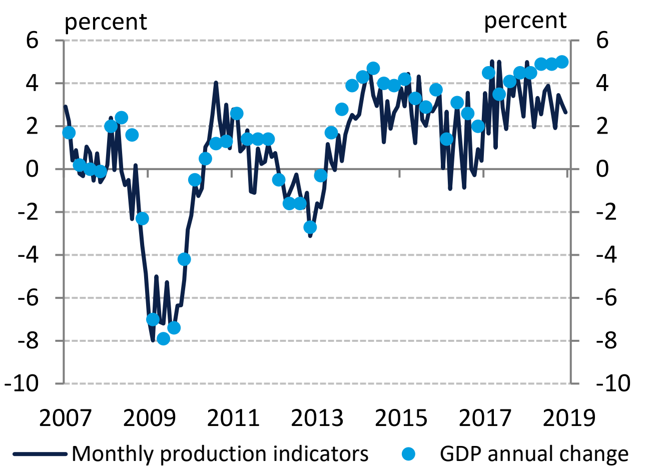
Growth prospects of the euro area continue to be dominated by downside risks. As regards the global economic activity, in the past months the continuance of trade tensions represented the most significant money market and growth risk. In addition, identifiable downside risks affecting European growth include the deteriorating industrial production observed in the past period, the 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 and the vulnerability of Italy stemming from the high government debt continue to be represented as risks.

Euro area inflation remained below the target in January. As a result of the decline in oil prices, the consumer price index fell to 1.4 percent, while core inflation stood at 1.1 percent, caused by the rise in the services' price dynamics. The personal consumption expenditures (PCE) index, i.e. the inflation indicator closely monitored by Fed, decelerated to 1.8 percent in November, while the Chinese consumer price index dropped to 1.7 percent in annual terms in January. Oil world market price in February rose above USD 65 (Chart 2). The rise in prices was attributable to the declining supply resulting from the agreement reached in December last year by the OPEC member states to cut oil production. World market prices of industrial commodities and unprocessed food were up in January.

1.2. Domestic real economy developments

According to the HCSO's preliminary data, in the fourth quarter of 2018, Hungary's gross domestic product rose by 5.0 percent year on year. Most of the national economy branches supported the growth; market services contributed to the largest degree to the increase in GDP. In the fourth quarter of 2018, in parallel with the rise in labour force participation rate and employment, the seasonally adjusted unemployment rate fell to 3.7 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



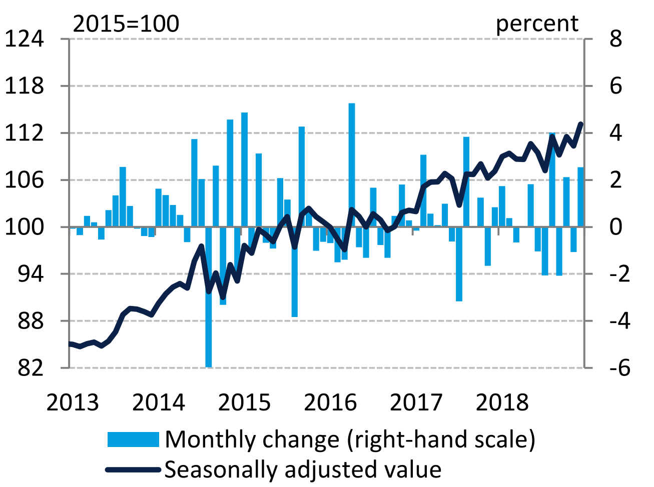
Note: Weighted average of monthly production indicators (industrial output, construction output and retail sales). The weights are derived from regression explaining GDP growth.
Source: MNB calculation based on HCSO data

1.2.1 Economic growth

According to HCSO's preliminary data release, in the fourth quarter of 2018, 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. **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 may have been supported to the greatest degree by the dynamic rise in internal demand factors, i.e. consumption and investment.**

In December 2018, **industrial output was up by 5.4 percent** year on year, while production **declined by 2.5 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 electronic products, as well as the food industry provided considerable support for the buoyant growth in industrial production. German industrial production showed a persistently decreasing trend in the past months, and it repeatedly declined in December; in addition, the new order portfolio of the German industry continued to decrease in year-on-year terms.

Chart 4: Development in industrial production

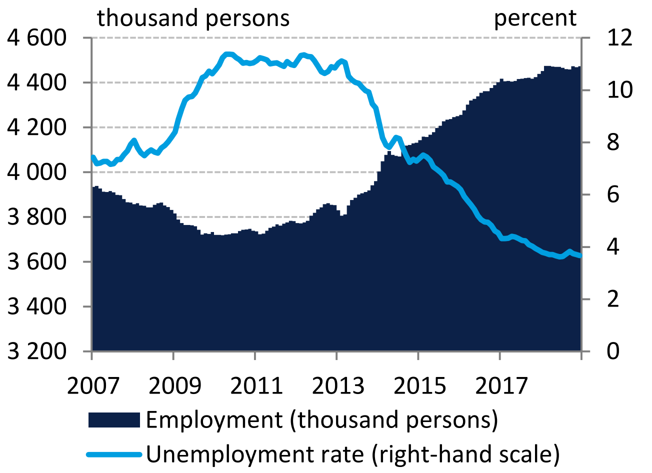


Source: MNB calculation based on HCSO data

Expressed in euro terms**,** the value of exports – **in parallel with the industrial production –** was up by 2.7 percent, while that of imports rose by 5.4 percent **year on year in December 2018, and thus trade surplus decreased by EUR 173 million. Export and import prices materially rose in November even in a historical comparison. In November 2018, the deterioration of the terms of trade decelerated – it decreased by 1.3 percent year on year –, caused by the rise in the relative price of mineral fuels and chemical goods**.

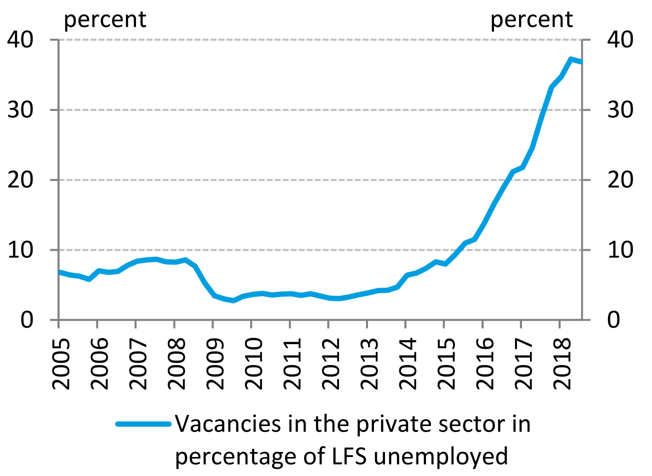
In December 2018, the volume of construction output was up 17.5 percent year on year, while output decreased by 2.4 percent compared to the previous month. Output increased both in the case of buildings and other structures. In the case of the construction of buildings, the growth in production was attributable to industrial, commercial and residential buildings. Due to the government investments, primarily to

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

infrastructure developments (road, railway, public utility), construction of other buildings rose. The **volume of new contracts substantially decreased** year on year, which is attributable to the high base of December 2017; within that, the number of contracts for buildings increased, while in the case of other structures a major year-on-year decrease was registered. The month-end volume of the construction companies' contract portfolio considerable fell short of the value registered a year ago in both groups of buildings.

In December, according to the preliminary data, **retail sales volume was up by 3.7 percent year on year, based on the seasonally unadjusted data**. According to the data adjusted for the calendar effect, the volume of sales grew by 4.1 percent year on year. Retail sales volume rose by 0.2 percent compared to the previous month. As regards the structure of retail sales – apart from the sales of food products – turnover continued to rise in a wide range of products in December. The substantial rise in the turnover of non-food consumer durables continued to support growth significantly, while the stagnation of the turnover in food products curbed the growth in total retail sales.

1.2.2. Employment

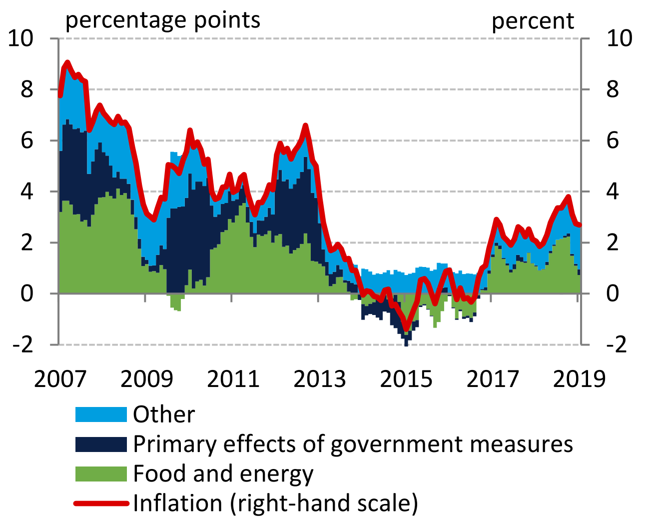
According to the (seasonally adjusted) data of the Labour Force Survey, in the fourth quarter of 2018, both the labour force participation rate and the number of people in employment rose. **The rise in total employment is related to the private sector,** while employment in the public sector has not changed significantly. The number of people in public employment fell to 131,000. Within the private sector, employment in manufacturing and construction increased, while employment in the market services sector declined. The number of people employed abroad rose to 110,000. **In parallel with the rise in labour force participation rate and employment, the unemployment rate fell to 3.7 percent** (Chart 5).

In the third quarter of 2018, based on the number of job vacancies, corporate labour remained high in manufacturing and continued to rise moderately 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).

1.3. Inflation and wages

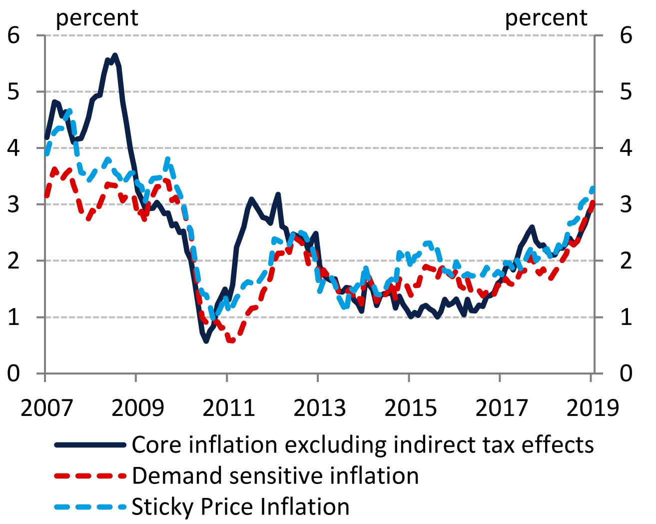
In January 2019, inflation stood at 2.7 percent, core inflation at 3.2 percent and core inflation excluding indirect taxes at 3.0 percent. Underlying inflation indicators rose compared to the previous month. In December 2018, gross average wage in the private sector rose by 10.1 percent year on year. The continued strong wage dynamics was supported, in addition to the historically tight labour market environment determining the underlying wage setting trend, by the raising of the minimum wage and guaranteed wage minimum by 8 and 12 percent, respectively, and the 2.5 percentage point reduction in the social contribution tax also supported corporate wage developments.

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 December 2018, gross average wage in the private sector rose by 10.1 percent year on year. The continued strong wage dynamics was supported, in addition to the **historically tight labour market environment** determining the underlying wage setting trend, by the **raising of the minimum wage and guaranteed wage minimum by 8 and 12 percent, respectively, and the 2.5 percentage point reduction in the social contribution tax also supported corporate wage developments**. Contrary to the seasonality usually observed in December, the regular average wage did not change on a monthly basis, while the degree of bonus payments was higher than in the previous years.

1.3.2. Inflation developments

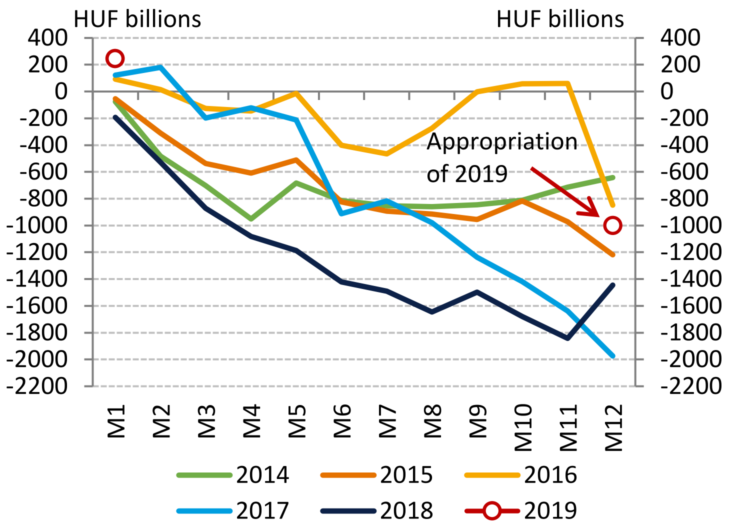
In January 2019, year-on-year inflation was 2.7 percent, while core inflation and core inflation excluding indirect taxes stood at 3.2 and 3.0 percent, respectively (Chart 7). Inflation has not changed compared to the previous month.

Core inflation excluding indirect taxes rose to 3.0 percent in January, mostly caused by the increase in the price of market services. **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 December 2018, agricultural producer prices rose by 5.8 percent in annual terms, while the domestic sales prices of the consumer goods industry increased by 2.3 percent.

1.4. Fiscal developments

The surplus of the central subsystem of the general government stood at HUF 244 billion in January 2019, which exceeds the cash balance registered in the first month of the previous years.

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



Source: Budget Act of 2018, Hungarian State Treasury

The surplus of the central subsystem of the general government stood at HUF 244 billion in January 2019, which exceeds the cash balance registered in the first month of the previous years (Chart 9). The substantial surplus registered in January is attributable to the cash revenues related to the large volume of EU transfers and to the dynamic growth in tax revenues.

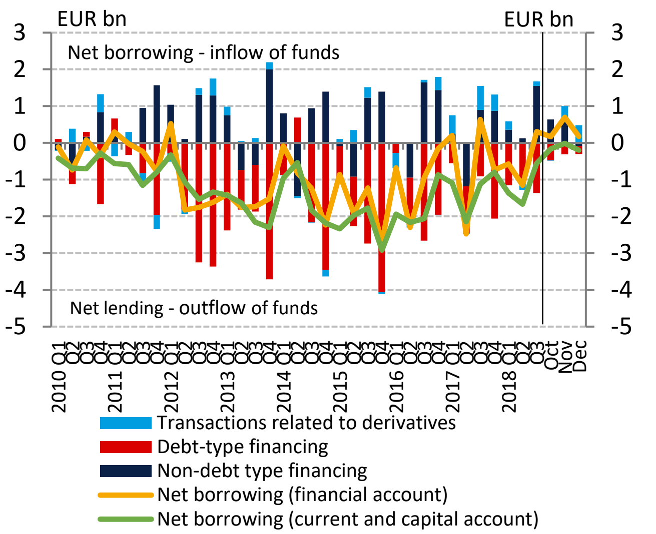
The **tax and contribution revenues of the central sub-sector** exceeded those registered in January 2018 by more than HUF 240 billion, which was partly due to the change in the rules of VAT refunds and to the dynamic rise in wage-related revenues. The cash revenues related to EU transfers exceeded the value registered in last January by more than HUF 220 billion.

The expenditures of the central sub-sector moderately rose in January 2019 year on year. Despite the considerable rise in the expenditures of the budgetary organisations, the expenditures of the sub-sector exceeded those registered in January last year only by roughly HUF 70 billion due to the decline in payments related to EU transfers. The substantial growth in the family allowances and social benefits is linked to the early payment of the February benefits.

1.5. External balance developments

In December, net lending of the economy rose to EUR 201 billion, which was achieved under a current account deficit of EUR 90 billion and a capital account surplus of EUR 291 billion. According to the financial account data, in December net FDI inflow and the decline in net external debt continued.

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 December, net lending of the economy rose to EUR 201 billion, which was achieved under a current account deficit of EUR 90 billion and a capital account surplus of EUR 291 billion. The moderate rise in the current account deficit was linked to a fall in the trade balance resulting from seasonal factors, while the capital account surplus was attributable to the substantial absorption of EU funds. The rising exports dynamics, resulting from the increasing industrial production, was exceeded by the growth rate of imports related to domestic demand items, which reduced the trade surplus. The rise in the absorption of EU transfers increased the transfer balance surplus, while no substantial change was registered in the income balance deficit during the month.

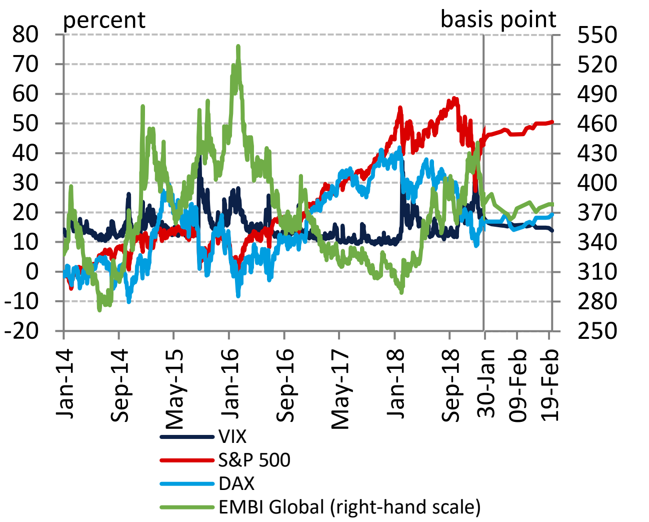
According to the financial account data, in December net FDI inflow and the decline in net external debt continued. The growth in net foreign direct investments was attributable to the rise in the intercompany loans and reinvested earnings of non-resident enterprises. The impact of the inflow of net foreign direct investments was offset by the outflow of funds related to the outward portfolio equity investments of residents, and thus the non-debt generating funds declined on the whole. Net external debt declined further by EUR 220 billion in December. The decline mostly related to the rise in foreign exchange reserves, but there was also a moderate decline in the net external debt of the corporate sector. The net external debt of the banking sector rose, since the decline in the sector's external assets exceeded the decrease in the debts (Chart 10).

2. Financial markets

2.1. International financial markets

Since the previous interest rate decision, global financial market sentiment developed more positively than in the previous period. This was primarily attributable to the more cautious communication of the world's leading central banks, the decreasing probability of another government shutdown in the United States and the press news on the favourable developments in the trade policy negotiations between the USA and China. However, anxieties about the global deceleration and developments related to the Brexit continue to cause uncertainty.

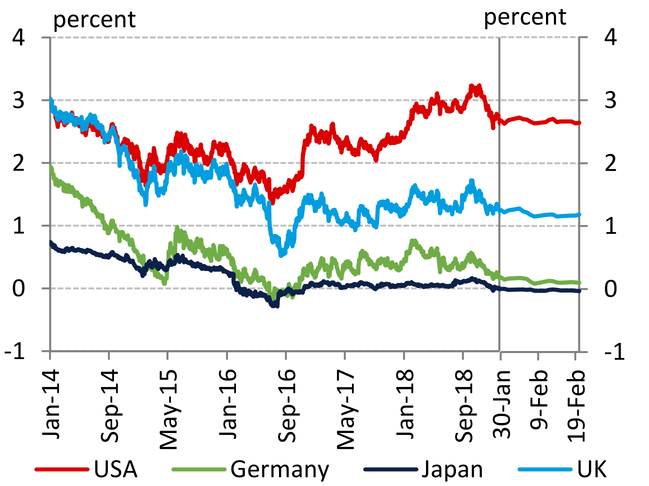
Chart 11: Developed market equity indices, the VIX index (left-hand scale) and the EMBI Global Index (right-hand scale)



Source: Bloomberg

Since the previous interest rate decision, global investor sentiment developed more favourably than in the previous period, since the probability of the occurrence of several negative risk factors declined. The VIX index declined by 5 percentage points compared to the level observed before the interest rate decision in January, and thus it was close to 15 percent at the end of the period (Chart 11). The bond market processes also reflected a decline in the aversion to risk: the emerging market EMBI Global spread declined further, and it continuously fluctuates below 400 basis points since mid-January, while in parallel with the improving sentiment, the MOVE index, measuring the volatility of the US bond market, declined from 50 basis points to 46 basis points. The developments in the market sentiment were primarily determined by the more cautious communication of the world's leading central banks, the decreasing probability of another government shutdown in the United States and the press news on the favourable developments in the trade policy negotiations between the USA and China. At the same time, anxieties about the slowdown of global growth and the developments related to the Brexit continue to cause uncertainty.

Chart 12: Yields on developed market long-term bonds

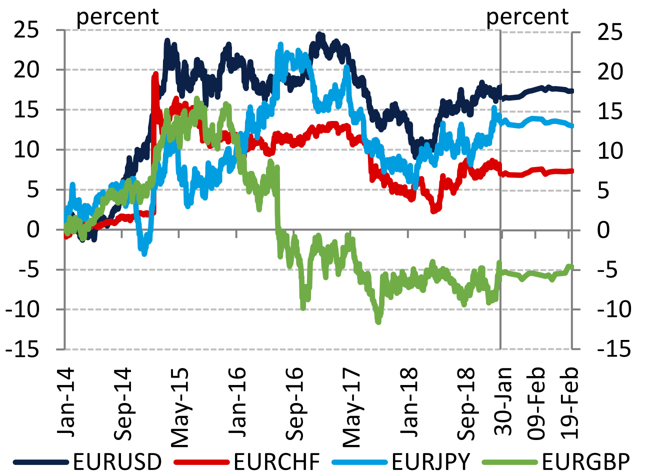


Source: Bloomberg

The US managed to avoid the repeated partial government shutdown. Although Donald Trump signed the budget bill of the Congress, which appropriates for the construction of the US-Mexican border wall a substantially lower amount than proposed by the President, President Trump threatened to declare state of emergency with a view to raising the initial amount necessary for building the wall.

The rumours about the favourable development in the USA - China talks substantially contributed to the improvement in sentiment; however, for the time being no specific announcements have been yet made. In mid-February there was a high-level meeting between the representatives of the two countries, and according to the press reports, progress was made at the negotiations towards an agreement, but no specific details have yet been revealed. According to the economists, an agreement may be reached, if at all, at the presidential-level meeting due in March or

Chart 13: Developed market FX exchange rates



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

April. Previously, the US President said that he was ready to prolong the deadline set by the USA, expiring on 1 March, if the position of the two parties came substantially closer to each other during the negotiations.

However, as regards the euro area, the recently published fourth-quarter GDP data have strengthened investors' concerns: on a quarterly basis, the German economy stagnated, while the Italian economy fell into recession. **In the past months, several signs pointed to the deceleration of growth in the German economy:** among other things, the business and household confidence indices, the new export orders and the manufacturing purchasing manager indices all developed well below the expectations.

Theresa May met the President of the European Commission in Brussels, to continue the negotiations on a potential solution, which makes the Irish backstop agreement acceptable for the Parliament of England. The government led by Theresa May is expected to submit an amended proposal to the Parliament at the next voting due on 27 February. If this motion is also rejected by the Parliament, according to the experts, chances that Great-Britain will have to initiate the extension of the end of March deadline for the exit increase.

Amid the favourable market sentiment, the developed stock exchange indices rose more vigorously, while emerging market indices recorded a moderate growth during the period under review. The largest increase was shown by the key US equity indices, which rose by more than 5 percent. The more positive news related to the trade dispute between the USA ad China, the pricing out expectations related to the interest rate hike by the central bank and the temporary loss of the importance of global growth concerns had favourable impact on the developed market stock exchange indices. Most of the European equity indices also rose, and thus the MSCI index, representing the developed markets, rose by 4.5 percent in total. At the same time, the composite MSCI index measuring the performance of the emerging market, showed a somewhat smaller, i.e. two percent, increase.

Both the developed and the emerging market long-term government securities yields declined. On the developed markets, the US long-term yield fell by 6 basis points to 2.65 percent, while the German yield decreased by 10 basis points to 0.1 percent and the Japanese long-term yield also declined by 2 basis points (Chart 12). As regards the periphery countries, only the Italian 10-year yield rose by 20 basis points as a result of the domestic political tensions, while the Portuguese and Greek yields declined in line with the global trends. The EMBI Global, representing the emerging bond markets, declined by 8 basis points in total during the period under review, which – just like the fall in the emerging long-term yields – reflects an improvement in the perception of the emerging region.

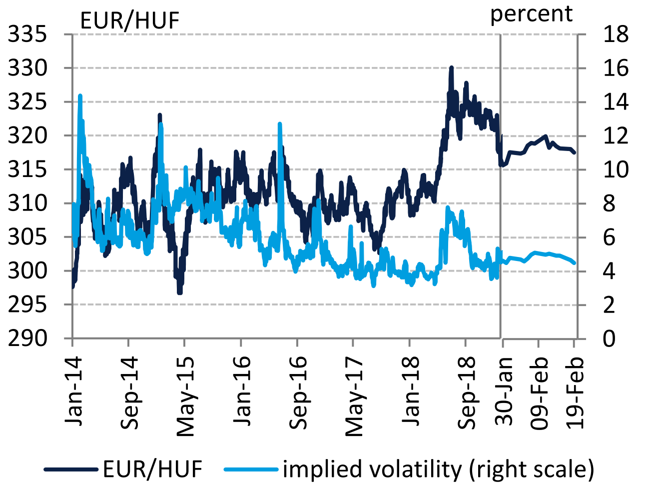
The dollar appreciated against most of the developed and emerging currencies. The dollar exchange rate appreciated against the euro, the Japanese yen and the Swiss franc by 1-1.5 percent in total, while its exchange rate against the British pound appreciated by almost 2 percent. During the period under review, most of the emerging currencies also depreciated against the dollar (Chart 13).

Oil prices, mostly as a result of the supply side developments, rose during the period under review. The price per barrel of the key oil types rose by 5-8 percent since the previous interest rate decision, while the year-to-date growth exceeds 20 percent. According to the latest OPEC report, the organisation reduced production by 800,000 barrels to 30.8 million barrels in January, i.e. it has essentially fulfilled its commitment specified in the agreement reached at the end of last year. Saudi Arabia played a key role in this, by cutting its production by roughly 450,000 barrels in December, followed by an additional cut of 350,000 barrels in January. However, the non-OPEC countries, which joined the voluntary production adjustment agreement, fulfilled their commitment to a much lesser degree. In addition, the US sanctions against Venezuela and Iran, the effect of which on oil supply is a source of major uncertainties, also represents a risk pointing to a price increase. At the same time, further price increase may be mitigated by the deceleration of the global economy and the record high US output.

2.2. Developments in domestic money market indicators

In the first half of the period elapsed since the previous interest rate decision, the forint depreciated and then appreciated, and thus on the whole it recorded only a minimum shift during the period. The 3-month BUBOR steadily stands at 15 basis points. The government securities yield curve became flatter, caused by a smaller decrease in short-term yields and a larger one in the long-term yields.

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

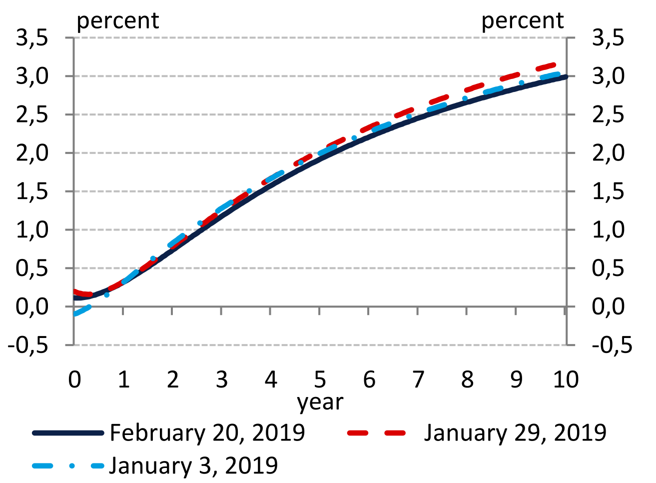


Source: Bloomberg

After the January interest rate decision, the forint exchange rate against the euro appreciated almost up to the level of 315, which was followed by a depreciation in the first half of February. At the same time, last week it appreciated almost back to the level observed at the previous interest rate decision, and thus, in a monthly aggregation, the forint depreciated by 0.2 percent. The currencies of the region fluctuated in a narrow band: the Czech koruna and the Romanian leu moderately appreciated, while the Polish zloty depreciated by 0.85 percent (Chart 14).

The 3-month BUBOR, relevant for the monetary policy transmission, has not changed and still stands at 15 basis points. **The up to 3 years section of the government yield curve has hardly changed, while it declined in the middle and longer sections.** The decrease in the short section amounted to 2-4 basis points, while the middle section declined by 10-14 and the 10-year section by 20 basis points, and thus the government yield curve became flatter on the whole (Chart 15).

Chart 15: Shifts in the spot government yield curve



Source: MNB, Reuters

The forint government bond auctions were characterised by strong demand. The average yield of the 3-month auctions was 0.02 percent during most of the period. The 3-month Treasury bill auctions were typically characterised by lower demand, but the Government Debt Management Agency accepted a lower volume than announced only at the first auction. At the 12-month Treasury bill auctions, the average auction yield decreased by 3 basis points to 0.38 percent under stronger demand. The auctions of the longer term government securities generally attracted strong demand, and thus in most of the cases the Government Debt Management Agency was able to augment the announced volume. Average yields typically declined compared to the previous period, particularly in the case of the 3-year securities.

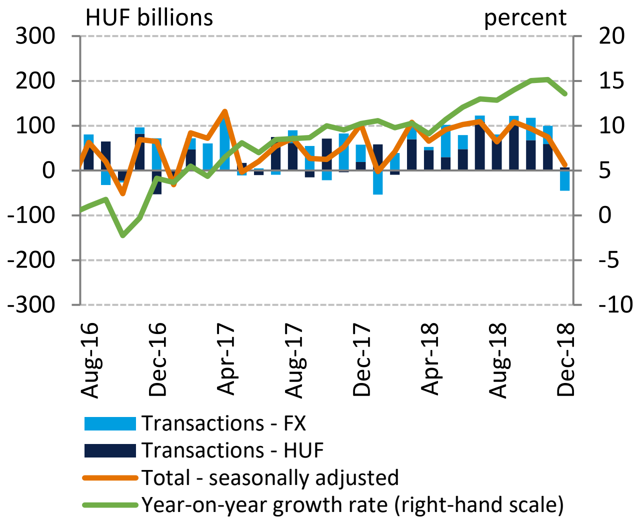
The 5-year Hungarian CDS spread has not changed, and thus it still stands at 86 basis points, in line with the steady level of the spreads in the region.

Non-residents increased their forint government securities holding slightly, by HUF 32 billion. Accordingly, the portfolio held by non-residents rose to around HUF 4,225 billion, while their share remained close to 23 percent.

3. Trends in lending

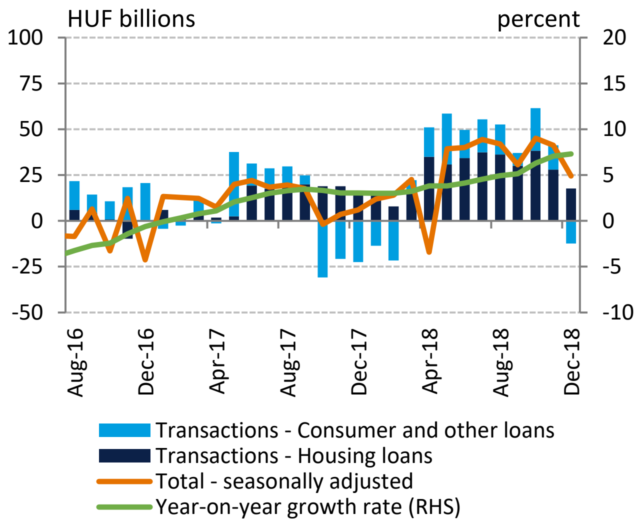
In December, the outstanding corporate loans of credit institutions fell by HUF 38 billion as a result transactions. The outstanding loans of credit institutions to households rose by HUF 5 billion as a result of transactions. Thus, at the end of 2018, the annual growth in outstanding lending amounted to 7.3 percent.

Chart 16: Net borrowing by non-financial corporations



Source: MNB

Chart 17: Net borrowing by households

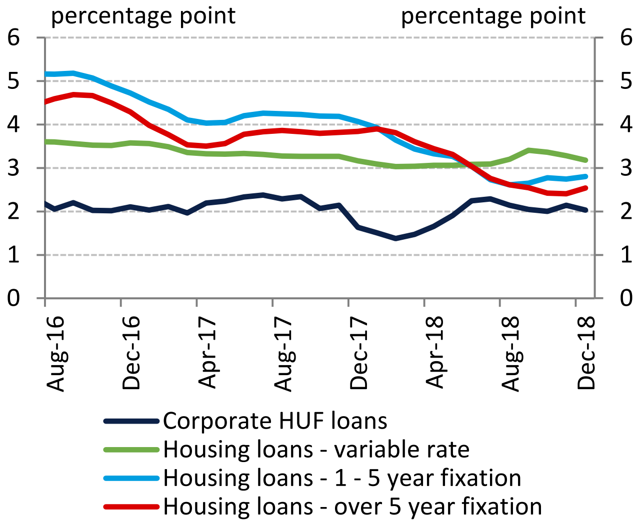


Source: MNB

In December, the outstanding corporate loans of credit institutions fell by HUF 38 billion as a result transactions (Chart 16). In a breakdown by currency, forint loans increased by HUF 7 billion, while foreign currency loans decreased by HUF 45 billion. At the end of 2018, the growth in corporate lending has slightly adjusted and decelerated to 13.6 percent. Excluding money market transactions, the volume of new loans amounted to HUF 221 billion during the month.

The outstanding loans of credit institutions to households rose by HUF 5 billion as a result of transactions. Thus the annual growth in outstanding lending amounted to 7.3 percent at the end of 2018 (Chart 17). The value of new contracts concluded during the month amounted to HUF 114 billion. The 12-month cumulated value of new loans rose by 31 and 47 percent in the case of housing loans and consumer loans, respectively. Since September 2017, the Certified Consumer-friendly Housing Loan products already contributed by HUF 336 billion to the growth in lending for housing purposes in a sounder structure, and 60 percent of the fixed-rate loans concluded during the month were already certified loans.

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

During 2018, the ratio of (variable rate) loans with interest fixed for 1 year at the most gradually declined, and amounted to 5.1 percent in December. Within the fixed-interest loans, from the second quarter, loans with interest period longer than 5 years increasingly gained ground, accounting for 69 percent of the total new housing loans in December. From 1 October 2018, the MNB introduced a new payment-to-income regime, differentiated by interest period, which is expected to divert demand toward loans with longer interest rate fixation, thereby reducing the interest rate risk of households.

The smoothed interest rate spread of forint corporate loans dropped by 15 basis points to 2 percentage points in December (Chart 18). However, the spread on small-amount market loans – typically taken by SMEs – exceeds the average of the other Visegrád countries by 80 basis points. The average smoothed interest rate spread on variable rate housing loans calculated on the basis of the annual percentage rate (APR) dropped by 10 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 145 basis points to 2.8 percentage points, while in the case of loans fixed for more than 5 years, it fell by 130 basis points to 2.55 percentage points, and thus at present the average spread on fixed-rate loans is already below that on the variable-rate loans.