MACROECONOMIC AND

FINANCIAL MARKET DEVELOPMENTS

BACKGROUND MATERIAL

TO THE ABRIDGED MINUTES OF THE

MONETARY COUNCIL MEETING

OF 29 JANUARY 2019

January

2019

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The background material 'Macroeconomic and financial market developments' is based on information available until 23 January 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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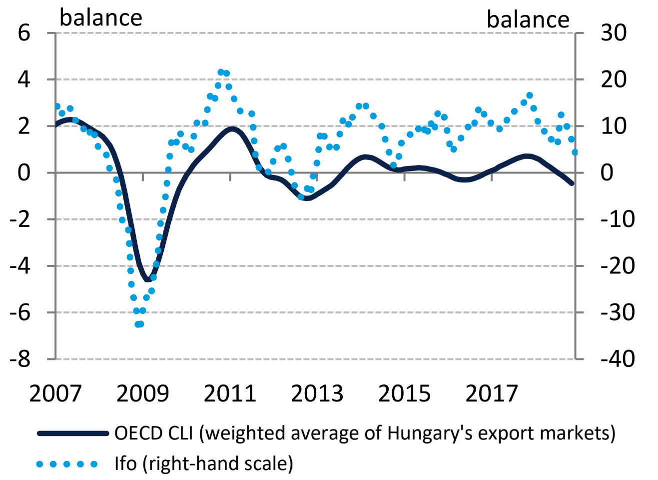
1. Macroeconomic developments

1.1. Global macroeconomic environment

In the third quarter of 2018, the GDP growth of the United States continued at a brisker, while the economic growth in the euro area at a decelerating rate. According to the international forecasts, on the whole, the growth prospects of the euro area deteriorated in the past months.

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



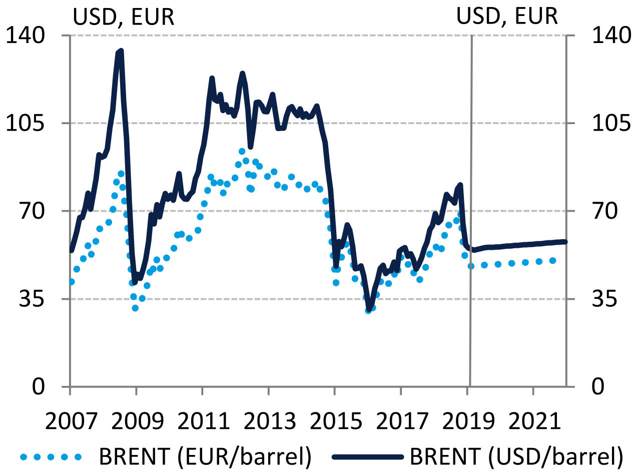
Source: OECD, Ifo

Growth in the global economy, and particularly in the USA and in the euro area, continued in the third quarter of 2018. The **US** economy grew at the fastest rate observed since 2015, by 3.0 percent in annual terms. Domestic demand was the key growth driver, while net exports materially curbed growth. 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 carries 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 third 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 1.6 and 0.2 percent, respectively.** The economic performance of Germany, Hungary's key trading partner, materially decelerated in 2018; in annual terms, the German GDP rose by 1.5 percent. The quarter-on-quarter decline 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 November, contributed to by a wide range of subsectors. In November, new orders of the Germany industry once again – already for the sixth month – declined year on year, although the new orders of the vehicle industry already rose in October and November compared to the previous month. In addition, the Ifo index, capturing the outlooks of the German economy, declined to a trough of almost 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 third quarter of 2018 as well. According to the seasonally adjusted data, in the third quarter Poland, Slovakia and the Czech Republic recorded a GDP growth of 5.7 percent, 4.5 percent and 2.4 percent,

Chart 2: World market prices of Brent crude oil



Source: Bloomberg

respectively. Following the outstanding growth registered in 2017, Romania's economic performance decelerated further in the third quarter, and the Romanian GDP rose by 4.2 percent year on year. Growth in the countries of the region was still supported by the dynamically increasing domestic demand.

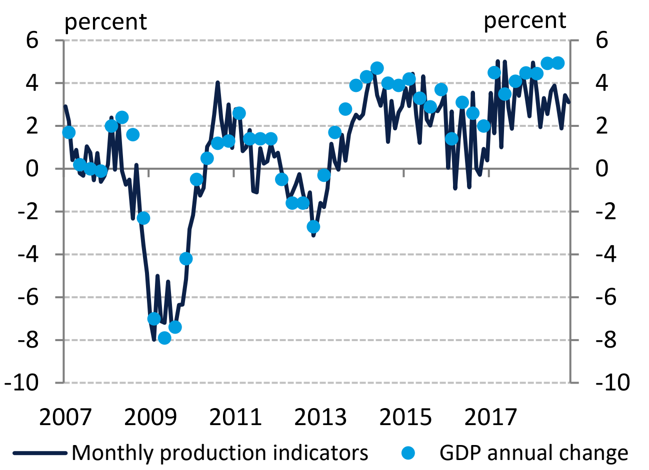
Growth prospects of the euro area continue to be dominated by downside risks. As regards the global economic activity, in the past months the increase in trade tensions remained the most significant money market and growth risk. In addition, identifiable downside risks affecting European growth include 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 its high government debt continue to represent risks.

Underlying inflation in the euro area remained essentially unchanged in December. As a result of the decline in oil prices, inflation fell to 1.6 percent, while core inflation remained 1 percent. The world market price of crude oil declined close to USD 50 by the end of December (Chart 2). The fall in oil prices was attributable to the oversupply at the end of the year and to the unfavourable news related to global economic activity. Following the decline registered at the end of the year, in January 2019 the Brent price per barrel rose to USD 60. World market prices of industrial commodities and unprocessed food remained essentially unchanged in December.

1.2. Domestic real economy developments

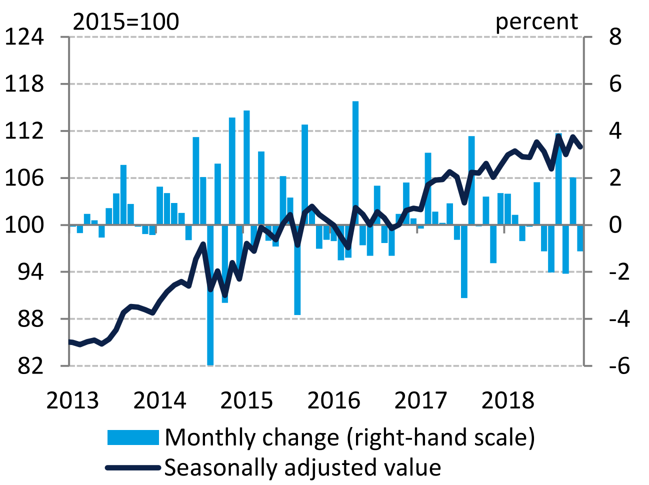
According to the HCSO's data, in the third quarter of 2018, Hungary's gross domestic product rose by 4.9 percent year on year. Most of the national economy branches supported the growth; market services contributed to the largest degree to the increase in GDP. In parallel with the stagnation of the labour force participation rate and employment, the unemployment rate was 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

Chart 4: Development in industrial production



Source: MNB calculation based on HCSO data

1.2.1 Economic growth

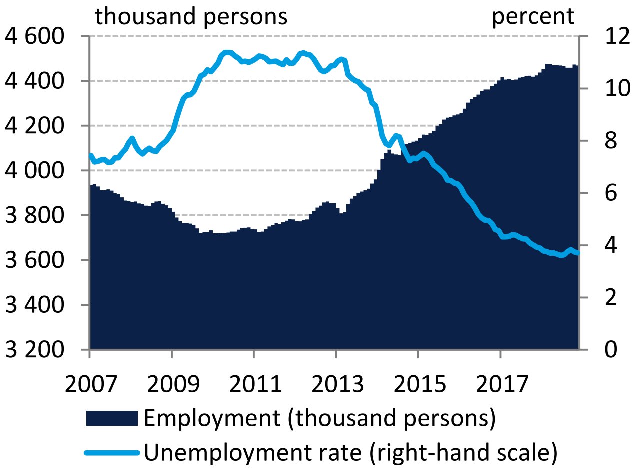
According to HCSO's data release, in the third quarter of 2018, Hungary's gross domestic product rose by 4.9 per cent year on year. Based on the seasonally and working-day adjusted data, **Hungary's GDP rose by 1.3 percent quarter on quarter.** From the output side, most of the national economy branches contributed to the growth, and market services supported GDP growth to the largest degree (Chart 3).

In November 2018, **industrial output was up by 4.0 percent** year on year, while production **declined by 1.1 percent compared to the previous month** (Chart 4). On the whole, the output of subsectors showed a positive picture; **following the more moderate performance observed in the previous months, the output of vehicle manufacturing – representing a considerable weight – rose again**; in addition, the manufacture of electronic products, as well as food industry and chemical industry output also substantially increased. German industrial production was moderate in the past months, and it repeatedly declined in November; in addition, the new orders of the German industry decreased again in year-on-year terms.

Expressed in euro terms, the value of exports – in parallel with the industrial production – **was up by 4.7 percent, while that of imports rose by 7.3 percent** year on year in November 2018, and thus trade surplus decreased by EUR 186 million. Export and import prices materially rose in October even in a historical comparison. In October 2018, the terms of trade have deteriorated by 2.0 percent year on year, caused by the rise in the relative price of mineral fuels and processed goods.

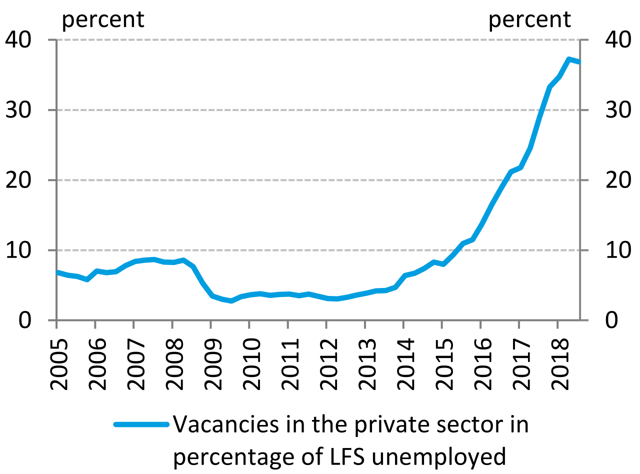
In November 2018, the volume of construction output was up by 27.3 per cent year on year, while output increased by 4.4 per cent compared to the previous month. Output increased both in the case of buildings and other structures. In the case of the construction of buildings, the growth in production was attributable to industrial, commercial and residential buildings. Due to the government investments, primarily to infrastructure developments (road, railway, public utility), construction of other buildings continued to rise. The **volume of new contracts substantially rose** year on year; within that the volume of contracts for buildings

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

and other structures both rose compared to the value registered in the previous year. The month-end volume of the construction companies' contract portfolio still substantially exceeds the level of last year, which primarily reflects the housing market contracts committed until 2019 and the already committed EU funds.

In November, according to the preliminary data, **retail sales volume was up by 5.3 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 5.2 percent year on year. Retail sales volume rose by 0.3 percent compared to the previous month. As regards the structure of retail sales, turnover continued to rise in a wide range of products in November. The substantial rise in the turnover of non-food consumer durables continued to support growth significantly.

1.2.2. Employment

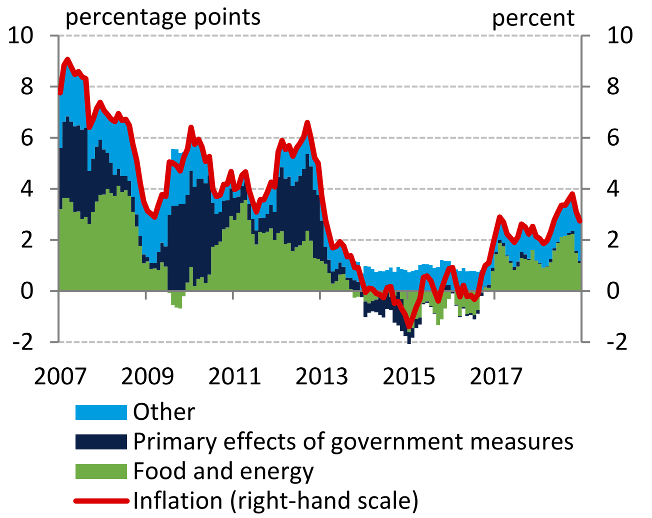
According to the (seasonally adjusted) data of the Labour Force Survey, in the period of September-November 2018, no significant change was registered in the labour force participation rate and in the number of people in employment. Within total employment, the minor fall in public employment was accompanied by a moderate rise in the number of people employed abroad; on the whole, the rise in employment on the primary labour market did not continue either. **In parallel with the stagnation of the labour force participation rate and employment, the unemployment rate was 3.7 percent** (Chart 5).

In the third quarter of 2018, the number of job vacancies remained high in manufacturing, while corporate labour demand 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 December 2018, inflation stood at 2.7 per cent, core inflation at 2.8 per cent and core inflation excluding indirect taxes at 2.9 per cent. Underlying inflation indicators moderately rose compared to the previous month. In November 2018, gross average wage in the private sector rose by 10.6 percent year on year. The continued vigorous 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 the guaranteed wage minimum by 8 and 12 percent, respectively.

Chart 7: Decomposition of inflation



Source: MNB calculation based on HCSO data

1.3.1. Wage setting

In November 2018, gross average wage in the private sector rose by 10.6 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**. No material change was recorded in the regular average wage on a monthly basis. Wage dynamics in sectors with below-average wage was still higher than in sectors with above-average wage, although the difference declined approaching the year-end.

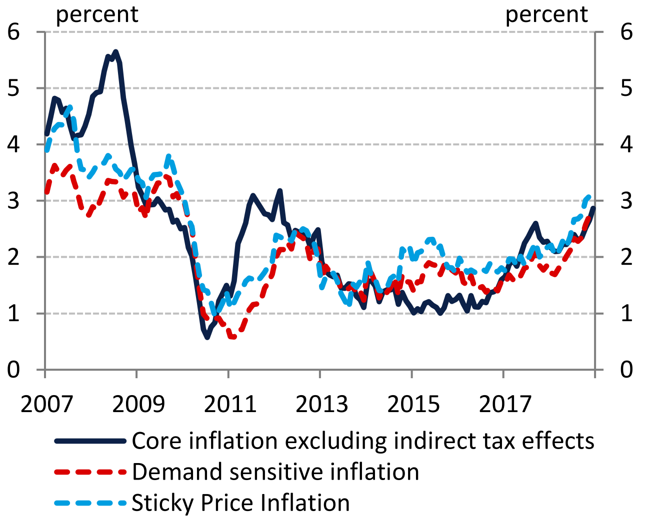
1.3.2. Inflation developments

In December 2018, year-on-year inflation was 2.7 per cent, while core inflation and core inflation excluding indirect taxes stood at 2.8 and 2.9 per cent, respectively (Chart 7). Inflation fell by 0.4 percentage point compared to the previous month, which was attributable to the fall in fuel prices.

Core inflation excluding indirect taxes somewhat rose in December, mostly caused by the increase in the price index of processed food. **No material change was registered in the rest of the underlying inflation indicators capturing the more permanent trends** (annual inflation of demand sensitive and sticky price products and services) (Chart 8). In November 2018, agricultural producer prices rose by 4.4 percent in annual terms, while the domestic sales prices of the consumer goods industry increased by 2.1 percent.

The December data corresponded to the projection in the December Inflation Report. According to the projection of the MNB's December Inflation Report, inflation will start to increase again from the beginning of next year.

Chart 8: Measures of underlying inflation indicators

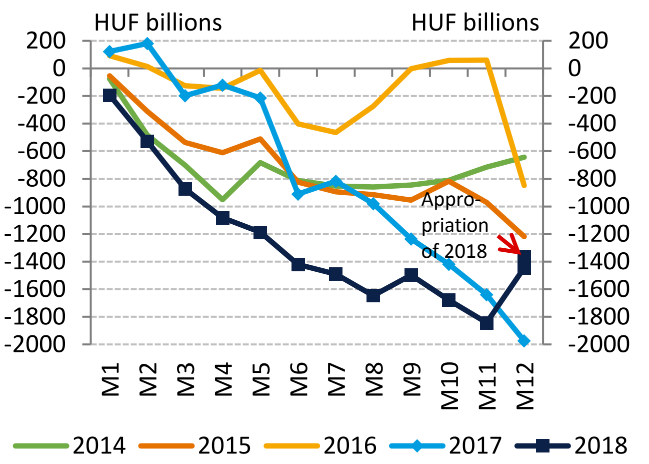


Source: MNB calculation based on HCSO data

1.4. Fiscal developments

In December 2018, the central sub-sector of the general government closed with a surplus of HUF 397 billion, and thus the current year's cumulated deficit amounted to HUF 1,445 billion at the end of December, representing a materially lower deficit than registered in 2017, and it only slightly exceeds the appropriation in the 2018 Budget Act.

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



Source: Budget Act of 2018, Hungarian State Treasury

In December 2018, the central sub-sector of the general government closed with a surplus of HUF 397 billion, and thus the cumulated deficit considerably declined in the last month of the year (Chart 9). The annual cash deficit amounted to HUF 1,445 billion in 2018, representing a substantially lower value compared to the 2017 deficit, and it only slightly exceeds the cash deficit target in the 2018 Budget Act.

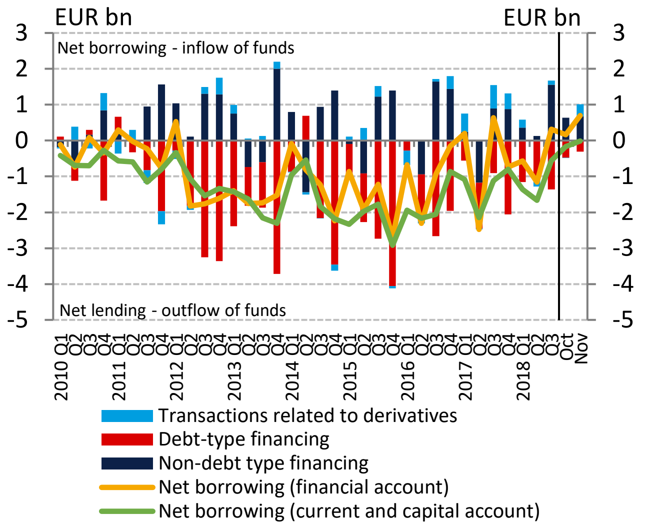
In December 2018, the **revenues of the central sub-sector** exceeded the December 2017 value by HUF 227 billion. The rise of HUF 60 billion in the net VAT revenues is attributable to the change in the reimbursement rules, as from January 2018 the reimbursement deadline decreased from 45 days to 30 days in the case of reliable debtors. Wage-related revenues increased by HUF 35 billion in December 2018, year on year. The revenues related to EU transfers exceeded the 2017 December value by HUF 107 billion.

The **expenditures of the central sub-sector** fell short of the December 2017 value by HUF 506 billion. A significant part of the difference arose at the expenditures related to EU transfers, caused by the retention of the EU advances. In addition, the expenditures of the budgetary organisations and those related to state property also fell short of the 2017 December value.

1.5. External balance developments

In November, net lending of the economy and the current account moderately declined. According to the financial account data, in November the net external debt of the economy declined, while foreign direct investments continued to rise.

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 November, current account deficit amounted to EUR 56 million, while net lending of the economy declined to EUR 13 million. The moderate current account surplus registered in October turned slightly negative, contributed to both by the trade balance and the decline in the surplus of current transfers. 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 decline in the absorption of EU transfers reduced the transfer balance surplus. No significant change was observed in the income balance deficit during the month.

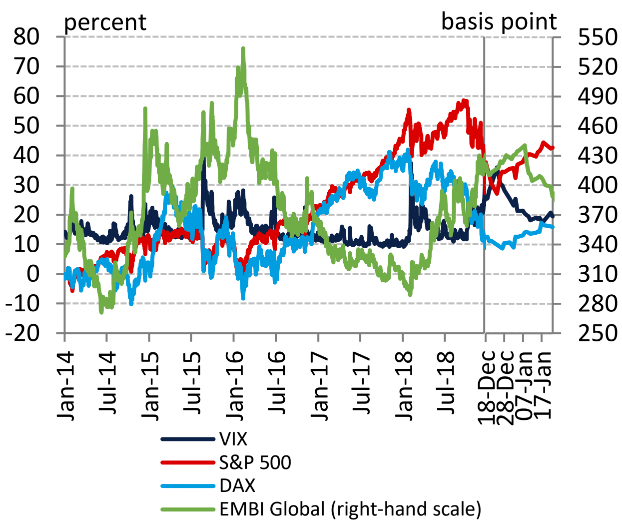
According to the financial account data, in November, the growth in net FDI and the decline in net external debt continued. The growth in net foreign direct investments was still mostly attributable to the reinvested earnings of enterprises. Net external debt declined further by EUR 310 billion in November. The decline related to the **banking sector**: the growth in external assets substantially exceeded the rise in external debt. The net external debt of the **general government** remained constant, while that of the **corporate sector** moderately rose (Chart 10).

2. Financial markets

2.1. International financial markets

Global market sentiment varied since the previous interest rate decision. Investor sentiment was primarily influenced by the communication of Fed, the developments related to the budget of Italy and to the Brexit, the trade policy negotiations between the USA and China, as well as the concerns surrounding the deceleration of the global economy. The VIX index, measuring stock exchange volatility, adjusted after the soar registered at the end of December, and it stood at 20 percent at the end of the period under review. Most of the developed stock markets and the emerging stock exchanges rose during the period. Developed and emerging long-term government securities yields both declined, with certain emerging markets (Turkey, Argentine) registering more substantial fall. No substantial change was registered in the dollar exchange rate against the euro, while the British pound, the Japanese yen and the emerging currencies appreciated against the euro. Oil prices rose during last month, and thus the Brent and WTI price stood at USD 61 and USD 53, respectively, at the end of the month.

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



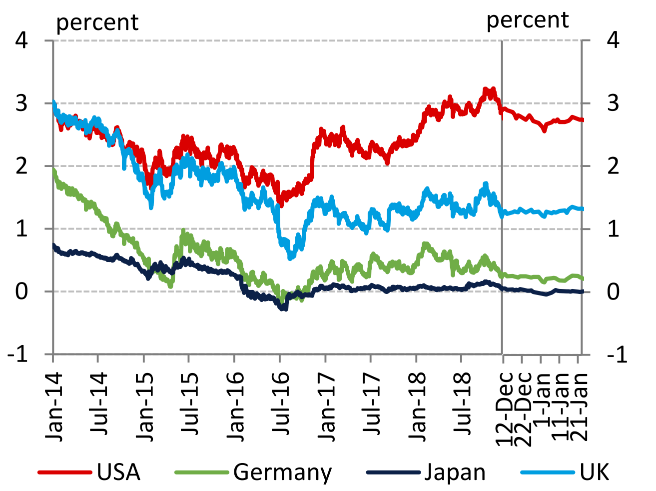
Source: Bloomberg

Global investor sentiment varied since the previous interest rate decision. The VIX index declined since the December interest rate decision by 6 percentage points, and thus it stood at 20 percent at the end of the period, while after the December interest rate decision it reached even 36 percent, a level unseen since the beginning of February 2018 (Chart 11). The bond market processes also developed similarly during the period under review: at the end of December, the MOVE index, measuring the volatility of the US bond market, rose from the initial 59 basis points to 68 basis points, and then – in parallel with the improving sentiment – dropped to 54 basis points. Market sentiment was primarily determined by the Fed's communication after the interest rate decision, the agreement reached in respect of the Italian budget, the developments in the trade negotiations between the USA and China, the developments related to the Brexit deal, and the concerns about the global deceleration.

Most of the developed market stock exchange indices, as well as the emerging markets rose during the period. Although at the beginning of the period, the key US equity indices continued the negative trend that commenced in early December, with the improvement in sentiment they rose by 4 percent in total compared to the date of the interest rate decision. Most of the European equity indices also rose; the German stock exchange closed the period positively, with a growth of more than 3 percent. However, the Japanese stock exchange recorded a loss of almost 2.5 percent. The developed market indices and the emerging market MSCI index were up by almost 4 and 5 percent, respectively.

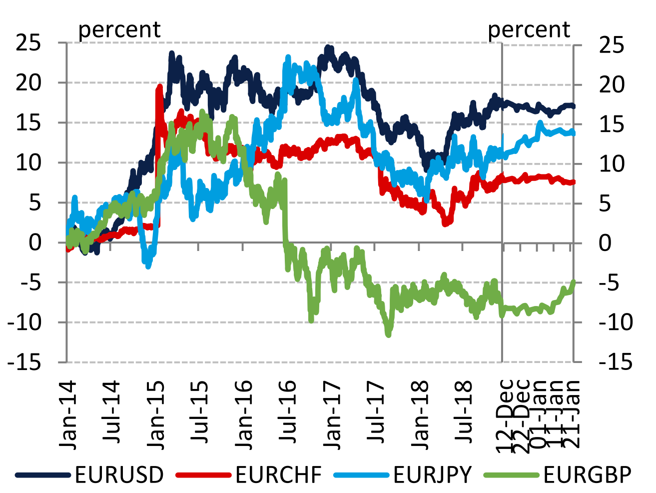
On the whole, developed market long-term government securities yields slightly declined, while emerging markets registered a significant decrease in long-term yields. On the

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

developed markets, the US long-term yield fell by 8 basis points to 2.73 percent, while the German yield decreased by 3 basis points to 0.21 percent and the Japanese long-term yield, already standing at an extremely low level, also declined by 3 basis points (Chart 12). The EMBI Global, reflecting the emerging bond markets, declined by 36 basis points in total during the period under review, with major contribution by the improving perception of Turkey and Argentine, while other emerging economies also registered a substantial decline in yields.

At its meeting of 19 December, the Fed – in accordance with the expectations – raised the interest rate by 25 basis points. In the communication after its interest rate decision, the central bank took a softer tone than before. The markets' expectations with regard to an interest rate hike declined to such an extent that they price no further tightening for 2019. In the case of ECB, based on the market pricings, the first increase of the overnight deposit interest was postponed from early next year to spring 2020.

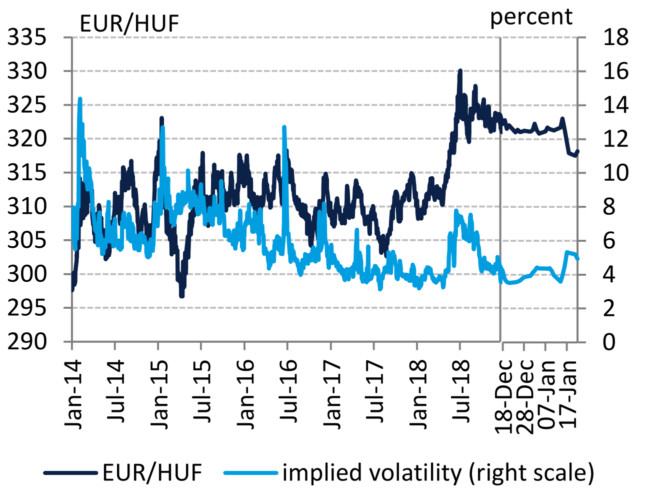
Developed currency exchange rates developed differently during the period under review, while emerging currencies appreciated in line with the market sentiment. The EUR/USD and the EUR/CHF exchange rate remained unchanged on the whole, and thus their exchange rate was still around 1.13, while the British pound and the Japanese yen appreciated by roughly 3 percent against the euro. Emerging currencies appreciated during the period under review (Chart 13).

Oil prices increased during the last one month. The price of the Brent and WTI crude oil rose by 10 and 14 percent to USD 61 and USD 53, respectively.

2.2. Developments in domestic money market indicators

In the first half of the period, the forint fluctuated in a narrow band, and after the central bank's communication related to normalisation, it closed the period with an appreciation of 1.5 percent. The 3-month BUBOR was up by 1 basis point. The government securities yield curve became flatter, caused by an increase in short-term yields and a decrease in the long-term ones.

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

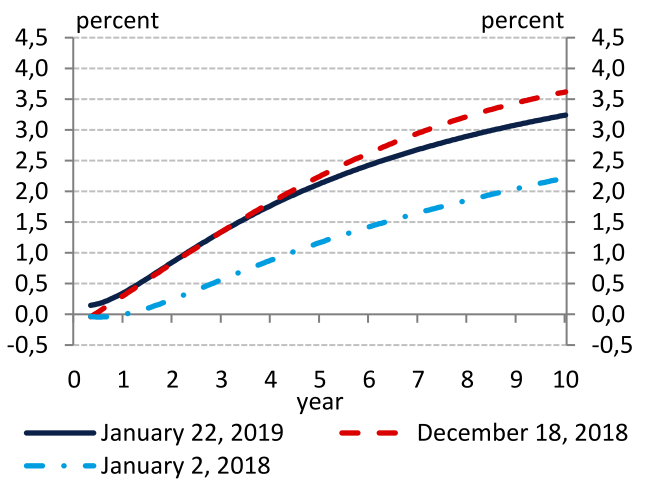


Source: Bloomberg

At the beginning of the period, the forint exchange rate against the euro fluctuated in the band of 321-323, followed by an appreciation of 1.5 percent after the central bank's communication on normalisation, and finally closed the period at an exchange rate around 318. Of the currencies of the region the Polish zloty and the Czech koruna fluctuated in a narrow band throughout the period, and thus the exchange rate of the Polish zloty essentially remained constant, while the Czech koruna appreciated by half percent. At the same time, the Romanian leu depreciated by 1.8 percent due to the anticipated tax on banks in Romania, and thereby it became the worst performing emerging market currency in the period under review (Chart 14).

The 3-month BUBOR, relevant for the monetary policy transmission, rose by 1 basis point to 14 basis points. **The government yield curve rose in the short section, while it declined in the middle and longer sections.** The growth in the short section amounted to 5-20 basis points, while the middle and longer sections declinedby 5-40 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

Average yields of the forint government securities auctions were mixed compared to early December. The average yield of the 3-month auctions rose to 0.05 percent in the second half of the period, while at the first auction of the period it still stood at -0.03 percent. Until early January the auctions of the 3-month securities were typically characterised by poor demand, as a result of which the Government Debt Management Agency raised less funds than the announced volume; however, from mid-January, it already sold the announced volumes as a result of the recovering demand. The 12-month discount Treasury bill auctions were also characterised by low demand in December, while it strengthened by January, and thus the announced volumes were sold under steady average yield of 0.41 percent. The auctions of the longer term government securities generally attracted strong demand, and thus in a few cases the Government Debt Management Agency was able to augment the announced volume. Average yields rose by 5-30 basis points at the individual maturities compared to the beginning of December.

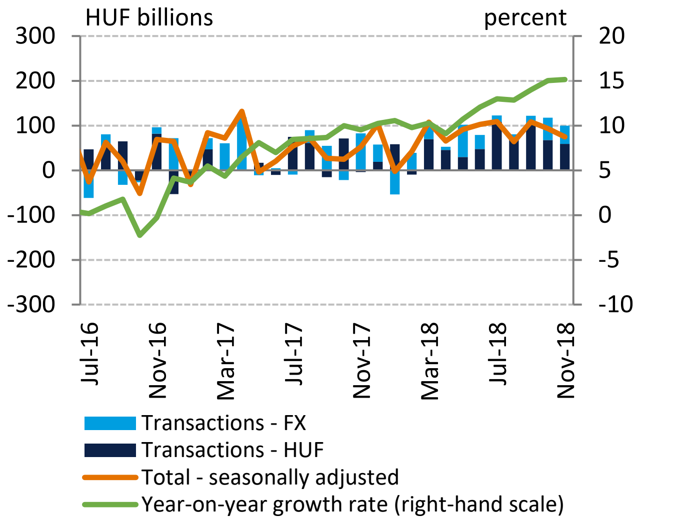
The 5-year Hungarian CDS spread still stands at 87 basis points, in line with the steady level of the spreads in the region.

Non-residents reduced their forint government securities holding slightly, by HUF 16 billion. Accordingly, the portfolio held by non-residents fell to around HUF 4,161 billion, while their share remained close to 23 percent.

3. Trends in lending

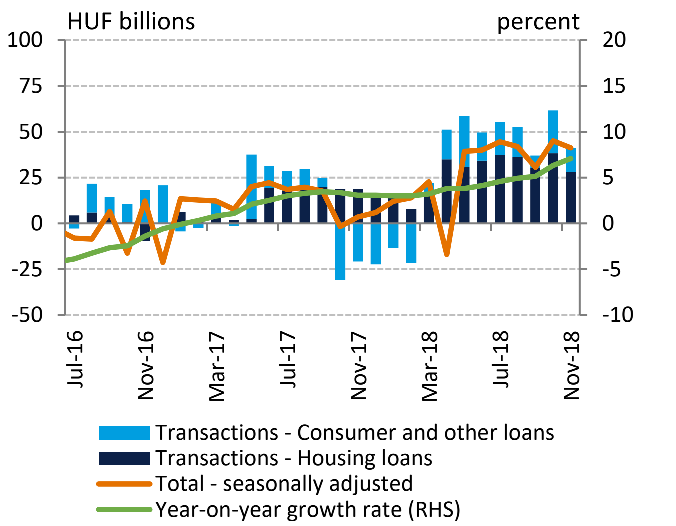
In November, the outstanding corporate loans of credit institutions rose by HUF 100 billion as a result of transactions. The outstanding loans of the credit institutions to households rose by HUF 41 billion, and thus in November 2018 the annual growth in outstanding lending amounted to 7 percent.

Chart 16: Net borrowing by non-financial corporations



Source: MNB

Chart 17: Net borrowing by households

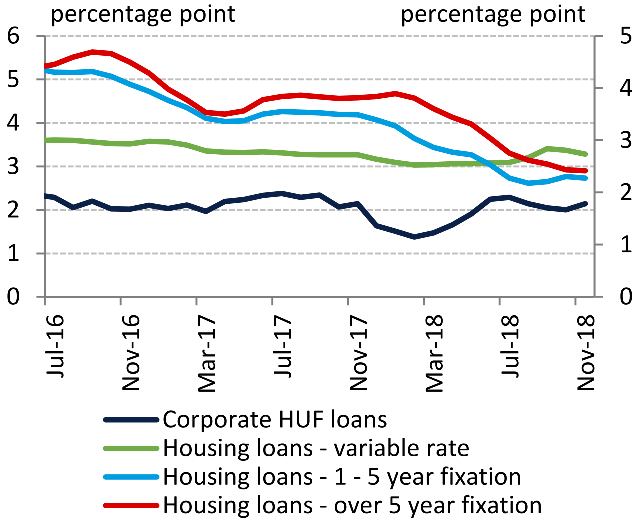


Source: MNB

In November, the outstanding corporate loans of credit institutions rose by HUF 100 billion as a result of transactions (Chart 16). In a breakdown by currency, forint loans and foreign currency loans increased by HUF 59 billion and HUF 41 billion, respectively. In November 2018, corporate lending rose by 15.1 per cent in annual terms. Excluding money market transactions, the volume of new loans amounted to HUF 225 billion during the month.

The outstanding loans of credit institutions to households rose by HUF 41 billion as a result of transactions. Thus, the annual growth in outstanding lending amounted to 7 percent in November 2018 (Chart 17). The value of new contracts concluded during the month amounted to HUF 140 billion. The 12-month cumulated value of new loans rose by 34 and 46 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 307 billion to the growth in lending for housing purposes in a sounder structure, and 58 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 loans with interest fixed for 1 year at the most gradually declined, and amounted to 5.8 percent in November. Within the fixed-interest loans, from the second quarter, loans with interest period longer than 5 years increasingly gained ground, accounting for 63 percent of the total new housing loans in November. 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 risk of households.

The smoothed interest rate spread of forint corporate loans rose by 15 basis points to 2.15 percentage points in November (Chart 18). However, the spread on small-amount market loans – typically taken by SMEs – exceeds the average of the other Visegrád countries by 75 basis points. The average smoothed interest rate spread on variable rate housing loans calculated on the basis of the annual percentage rate (APR) remained at the same level compared to September 2017 (the start of the Certified Consumer-friendly Housing Loans), and stood at 3.3 percentage points. In the case of loans the interest rate of which is fixed for 5 years at the most, this value dropped by 150 basis points to 2.75 percentage points, while in the case of loans fixed for more than 5 years, it fell by 140 basis points to 2.4 percentage points, and thus at present the average spread on fixed-rate loans is already below that on the variable-rate loans.