MACROECONOMIC AND

FINANCIAL MARKET DEVELOPMENTS

BACKGROUND MATERIAL

TO THE ABRIDGED MINUTES OF THE

MONETARY COUNCIL MEETING

OF 23 JULY 2019

July

2019

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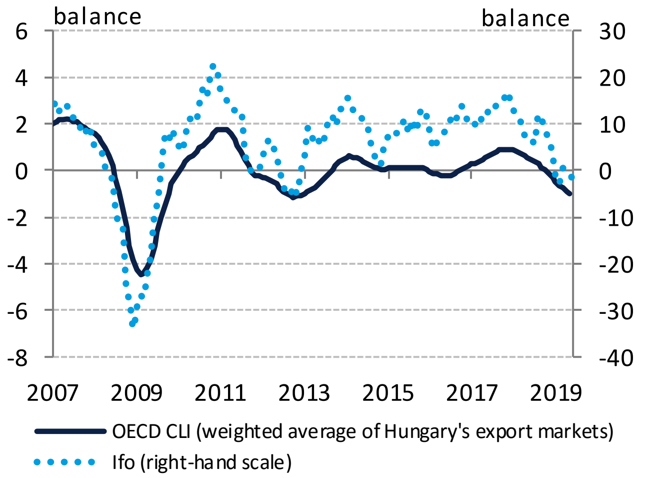
1. Macroeconomic developments

1.1. Global macroeconomic environment

In the first quarter of 2019, economic growth accelerated quarter on quarter both in the United States and in the euro area; however, growth prospects of the euro area are still dominated by downside risks. Growth of the CEE region substantially exceeds the growth rate of euro area.

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

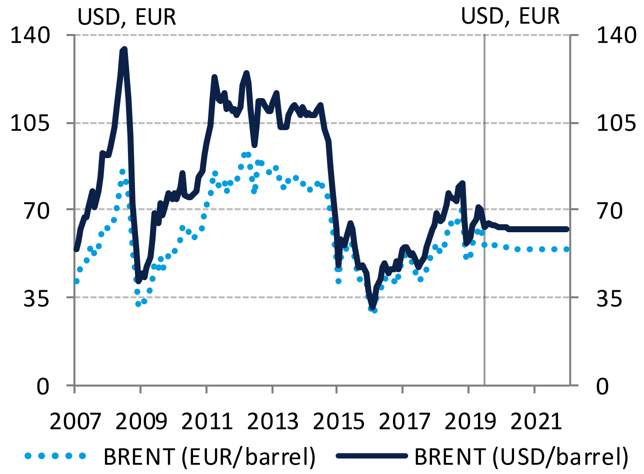


Source: OECD, Ifo

In the first quarter of 2019, growth in the global economy accelerated. The US economy rose by 3.2 percent on an annual basis. Quarterly growth was 0.8 percent, which indicates acceleration in the growth of US economy. Factors underlying economic recovery are primarily the soar in state government consumption and growth in investments. Consumption of households and the federal government slowed down. Net exports made positive contribution to economic performance, which was also supported by decelerating imports after the enforcement of the customs measures. In addition, inventories also made major contribution to growth. The prospects related to the growth of the US economy predict gradual deceleration in parallel with the run-out of the growth supporting measures (tax cuts and infrastructural investment programme). **The concerns related to the trade policy tensions play an increasingly prominent role in the fears in connection with the deceleration of the economy.** Due to the significant share of the United States within global imports, the potential tightening of the customs measures may have a substantial effect on global economy growth.

Economic growth in the **euro area** accelerated moderately in the first quarter. **The growth calculated on year-on-year and quarter-on-quarter basis was 1.2 and 0.4 percent, respectively. The economic performance of Germany,** Hungary's key trading partner, **rose by 0.4 percent on a quarterly basis.** The growth was primarily supported by construction and machine investments, as well as by households' consumption. However, Germany's industrial production, similarly to the previous months, declined further in May on an annual basis. New orders of the German industry also decreased year on year. **Despite the favourable GDP data registered in the first quarter, expectations with regard to the German economy's performance for this year continue to be unfavourable.** The Ifo index, capturing the outlooks of the German economy, declined further (Chart 1). **The impact of the German industrial trends on Hungary's prospects is qualified by the fact that in the past months we witnessed a decoupling process between the Central European and German industrial production.**

Chart 2: World market prices of Brent crude oil



Source: Bloomberg

In the first quarter, **the French economy** rose by 1.1 percent, supported by consumption on the expenditure side. After the positive contribution, registered in the previous two quarters, net exports were no longer able to support growth; it reduced GDP growth by 0.3 percentage point. The performance of the **Italian** economy moderately declined year on year. The economic growth of **Austria** continued, and at 1.4 percent it slightly exceeded the GDP growth of the euro area. The economic performance of the **United Kingdom** accelerated further last year, thereby achieving the highest growth of the past 5 quarters on an annual basis. The economic growth was supported by domestic items, while net exports made negative contribution in the first quarter.

As in the previous quarters, the Central and Eastern European region proved to be the growth centre of the European Union also at the beginning of 2019. According to the seasonally adjusted data, in the first quarter Poland, Romania, Slovakia and the Czech Republic recorded a GDP growth of 4.7 percent, 5.1 percent, 3.8 percent and 2.6 percent, respectively. Examining the region as a whole, domestic demand acts as the main driver of growth**,** and in general the region is characterised by decoupling from the German cyclical developments.

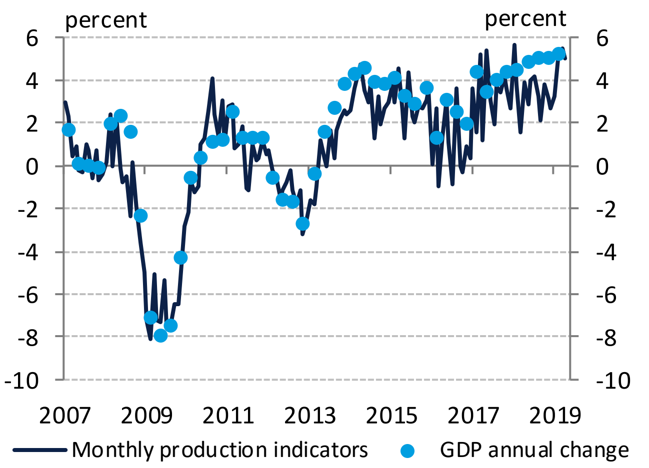
Growth prospects of the euro area continue to be dominated by downside risks. Growth may be curbed by the deteriorating industrial production observed in the past period, attributable to the increase in trade tensions, the vulnerability of Italy stemming from the high government debt, the indirect effects of the deceleration of the Chinese economy and the uncertainty resulting from the fragile financial environment on the emerging markets. In addition, the uncertainty surrounding the exit of the United Kingdom from the EU continues to represent risk and the "fallout" of the United Kingdom from the EU (hard Brexit) remains a realistic scenario. As regards the global economic activity, the increase in trade tensions remained the most significant money market and growth risk in the past months.

Underlying inflation measured in the euro area moderately rose in June. Accordingly, inflation stood at 1.3 percent and core inflation at 1.1 percent. The **world market price of crude oil,** with substantial volatility, **declined by the end of the period.** (Chart 2). In the past week, the developments in prices were shaped by opposite effects: concerns related to deceleration in global demand pointed to a decrease in prices, while growing geopolitical tensions between the USA and Iran, as well as the larger-than-expected decline in US oil reserves supported an increase in prices. The traditional meeting of the OPEC and OPEC Plus countries in Vienna was held on July 1 and July 2, where – in accordance with the expectations – the agreement on the restriction of output was prolonged by 9 months, until May 2020. Oil price essentially remained unchanged as a result of the decision, since the developments in prices are influenced primarily by the degree of the restriction rather than by the duration of the agreement. The rise in oil prices to USD 67 in the period under review was supported by several factors: US oil reserves declined further, while the drilling rigs in the Gulf of Mexico had to be evacuated due to storm warning; in addition, tensions in the Middle East also escalated. World market prices of industrial commodities and unprocessed food declined in June.

1.2. Domestic real economy developments

According to the HCSO's data, in the first quarter of 2019, Hungary's gross domestic product rose by 5.3 percent year on year. Growth was still supported primarily by buoyant domestic demand. In the period of March to May, seasonally adjusted unemployment rate remained at 3.4 percent. In the first quarter of 2019, based on the number of job vacancies, corporate labour demand decreased in a wide range of the sectors.

Chart 3: Monthly production indicators and GDP growth



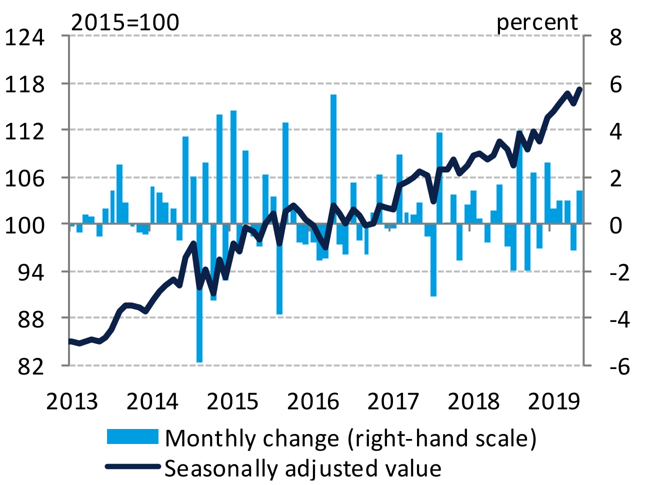
Note: Weighted average of monthly production indicators (industrial output, construction output and retail sales). The weights are derived from regression explaining GDP growth.
Source: MNB calculation based on HCSO data

1.2.1 Economic growth

According to HCSO's data release, in the first quarter of 2019, Hungary's gross domestic product rose by 5.3 percent year on year. Based on the seasonally and working-day adjusted data, Hungary's GDP **rose by 1.5 percent quarter on quarter.** Based on the currently published data, Hungary is ranked second, behind Ireland, in the EU member states' growth ranking in year-on-year terms. From the output side, most of the national economy branches contributed to the growth, and market services, together with construction, supported GDP growth to the largest degree (Chart 3). In addition, despite the decelerating German industrial orders, industry also made a positive contribution. From the expenditure side, the growth in economic performance was supported to the greatest degree by the dynamic rise in internal demand factors, i.e. consumption and investment.

In May 2019, **industrial output was up 8.7 percent** year on year, while production **rose by 1.4 percent compared to the previous month** (Chart 4). **The majority of the Hungarian manufacturing subsectors made positive contribution to growth:** according to the information provided by HCSO, **the growth of vehicle manufacturing, representing the highest weight, was outstanding compared to the previous months (17.2 percent).** In addition, the rise in the manufacture of computers, electronic and optical products exceeded the average of industrial production, while the manufacture of food, beverage and tobacco products was lower in May.

Chart 4: Development in industrial production

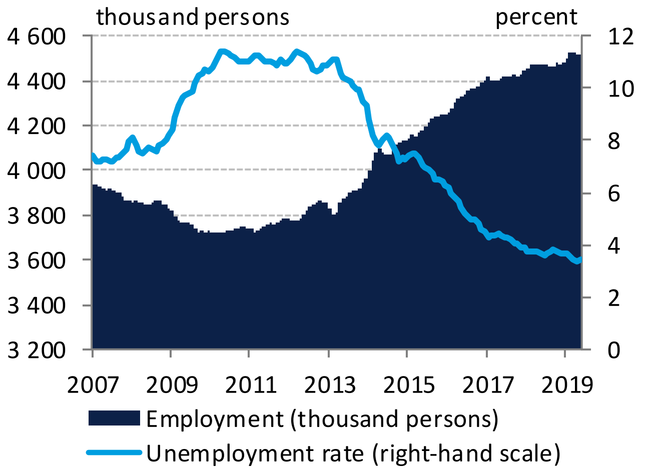


Source: MNB calculation based on HCSO data

Based on preliminary data, **expressed in euro terms, the value of exports was up by 4.5 percent, while imports rose by 2.6 percent,** year on year in May 2019, and trade surplus increased by EUR 185 million. In April 2019, the deterioration of the terms of trade continued in an annual comparison (0.4 percent), which was caused by the change in the price of mineral fuels.

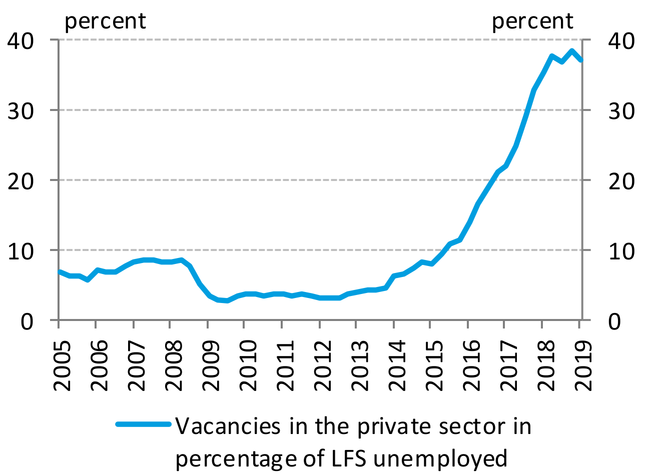
In May 2019, the volume of construction output was up by 26.3 percent year on year. Output increased both in the number of buildings and other structures. The growth in the construction of buildings was attributable to the construction of industrial and warehouse buildings. Due to the government investments, primarily to infrastructure developments (road, railway), construction of other structures increased further. The volume of new contracts decreased by 1.1 percent year on year; the number of

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

contracts for buildings fell by 24.0 percent, while it rose by 11.9 percent for other structures. The month-end volume of construction companies' contract portfolio rose by 38.4 percent for buildings, while it decreased by 19.1 percent for other structures.

In May, **retail sales volume, based on the data adjusted for the calendar effect**, rose at a slower rate than before, by **2.6 percent year on year.** According to the seasonally adjusted data, retail sales volume moderately decreased compared to the previous month. The rise in the turnover of consumer durables was attributable – in addition to the increase in car registrations and motor vehicle sales – to the growth in the turnover of shops selling manufactured goods, as well as of the mail order shops. The slowdown of the growth rate of the total retail sales volume is primarily attributable to the more moderate rise non-durable goods than before; growth in fuel sales materially decelerated compared to the previous month and a rise of 0.8 percent was observed. In May, the turnover of food stores and groceries, representing a considerable weight, showed slowdown compared to the previous months, year on year, which was primarily attributable to the fall in the sales of tobacco products.

1.2.2. Employment

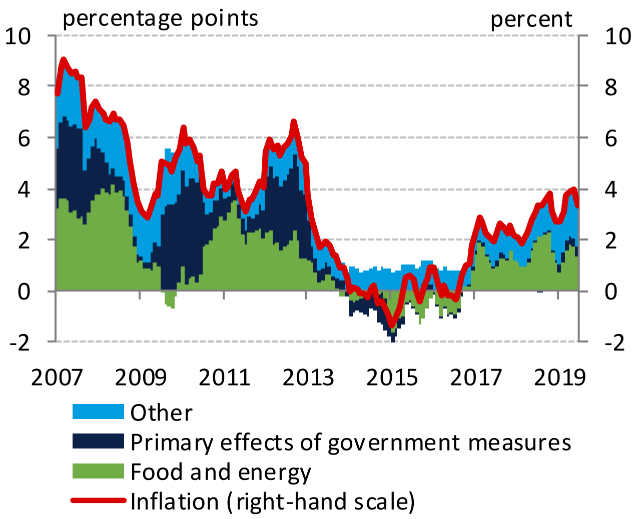
According to the (seasonally adjusted) data of the Labour Force Survey, in the period of March to May 2019, both the labour force participation rate and the number of people in employment remained essentially unchanged. The number of people in public employment declined further, while the number of people employed abroad stagnated. **Seasonally adjusted unemployment rate remained at 3.4 percent** (Chart 5).

In the first quarter of 2019, based on the number of job vacancies, corporate labour demand decreased in a wide range of the sectors. The **tightness indicator** calculated from the ratio of job vacancies and unemployed persons **remained at a high level**, but at the same time there was no substantial rise (Chart 6).

1.3. Inflation and wages

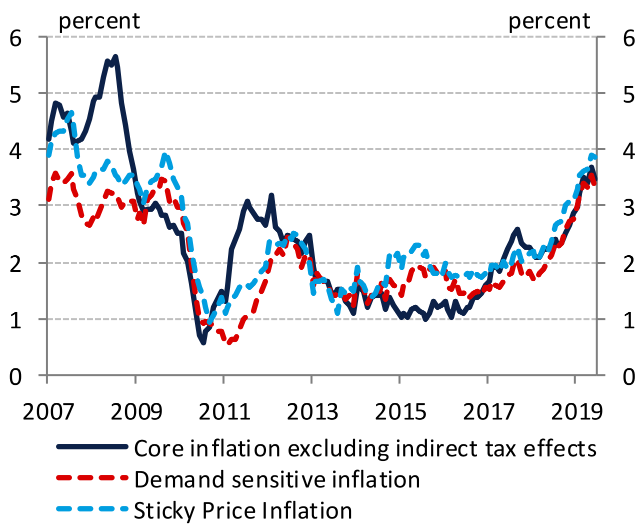
In June 2019, year-on-year inflation was 3.4 percent. Core inflation stood at 3.8 percent, while core inflation excluding indirect taxes was 3.5 percent. Underlying inflation indicators declined compared to the previous month. In April 2019, gross average wage in the national economy rose by 9 percent 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

Chart 8: Measures of underlying inflation indicators



Source: MNB calculation based on HCSO data

1.3.1. Wage setting

In April 2019, gross average wage in the national economy and in the private sector increased by 9 percent and 10.3 percent, respectively, year on year. The monthly increase in regular average wage was slightly lower than the usual seasonality. Within the private sector, the wage dynamics in manufacturing still substantially exceeds the wage growth of the market services sector, as the latter registered only a single-digit wage growth. 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

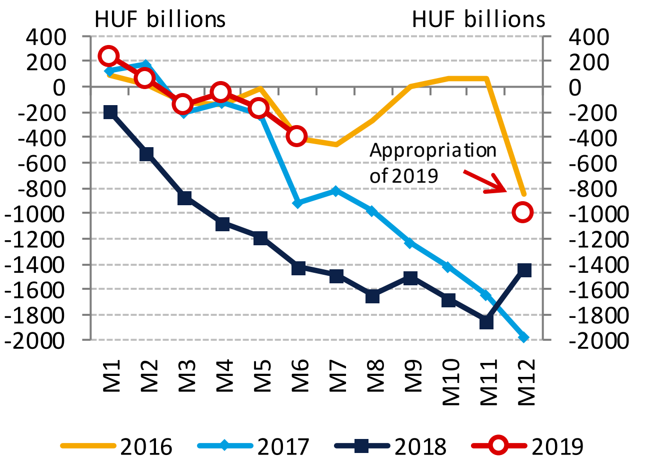
In June 2019, year-on-year inflation was 3.4 percent. Core inflation stood at 3.8 percent, while core inflation excluding indirect taxes was 3.5 percent (Chart 7)**.** Inflation fell by 0.5 percentage point, while **core inflation and inflation excluding indirect taxes both decreased by 0.2 percentage point,** compared to the previous month. The fall in inflation was primarily caused by fuel prices, while in core inflation by the decrease in the price index of alcohol and tobacco products. Market services prices essentially rose at the average rate of previous years in a monthly comparison.

The rest of the underlying inflation indicators capturing the more permanent trends (annual inflation of demand sensitive and sticky price products and services) **declined compared to the previous month** (Chart 8). In May 2019, agricultural producer prices rose by 6.0 percent in annual terms, while the domestic sales prices in sectors of the consumer goods producers increased by 5.2 percent.

1.4. Fiscal developments

In June 2019, the central sub-sector of the general government closed with a deficit of HUF 214 billion, and thus the deficit accumulated in the first half-year rose to HUF 390 billion, which is substantially lower than the cash deficit registered in the first half-year of the previous two years.

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



Source: Budget Act of 2019, Hungarian State Treasury

In June 2019, the central sub-sector of the general government closed with a deficit of HUF 214 billion, and thus the deficit accumulated in the first half-year rose to HUF 390 billion, which is substantially lower than the cash deficit registered in the first half-year of the previous two years (Chart 9).

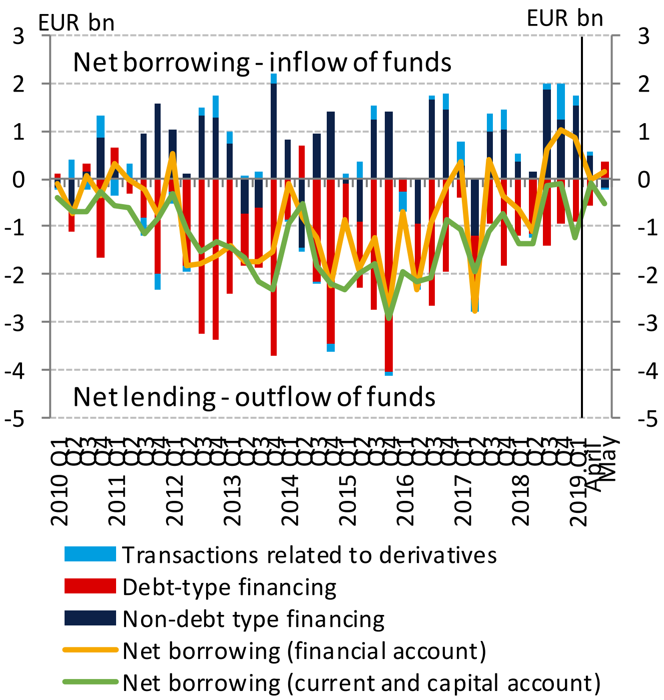
In June 2019, the **revenues of the central sub-sector** were up by HUF 50 billion year on year, which was mostly attributable to the rise in consumption tax and labour tax revenues. Gross revenues from value added taxes rose by 12 percent, while revenues related to wages and other earnings were up by 9 percent year on year.

In June 2019, the **expenditures of the central sub-sector** were up by HUF 30 billion year on year due to the higher expenditures of the central budgetary organisations, which was partially offset by the decrease in net interest expense. This month, the increase in the expenditures of the budgetary organisations appears at the expenditures of chapters, where the expenditures in June exceeded the amount registered one year ago by HUF 81 billion.

1.5. External balance developments

Compared to April, both net lending and the current account increased. According to the financial account data, there was an inflow of funds, realised under the continued growth in net FDI and a rise in net external debt.

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 May, current account surplus and net lending of the economy amounted to EUR 245 million and EUR 508 million, respectively. Compared to April, both net lending and the current account increased, which was primarily attributable to the growth in trade balance, and to a lesser degree to the higher absorption of EU transfers (Chart 10).

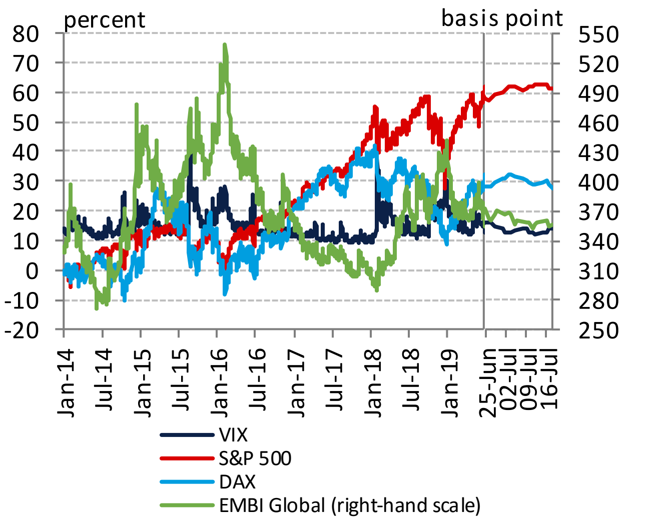
According to the financial account data, there was an inflow of funds, realised under the continued growth in net FDI and a rise in net external debt. The inflow of net FDI, amounting to almost EUR 30 million, was still primarily attributable to the reinvested earnings of non-resident corporations, which, however, was materially decelerated by the dividend payments of corporations, which may be regarded as a seasonal phenomenon. The inflow of net external debt of almost EUR 350 million primarily related to the purchase of government securities by non-residents.

2. Financial markets

2.1. International financial markets

Since the previous interest rate decision, global market sentiment moderately improved, which was primarily caused by the easing of the trade tensions. The US and European stock exchange indices increased, while the Japanese one recorded a decline. Yields on the developed market long-term government securities slightly increased, while emerging market long-term yields – with the exception of the Turkish and Argentine long-term yields – declined.

Chart 11: Developed market equity indices, the VIX index and the EMBI Global Index



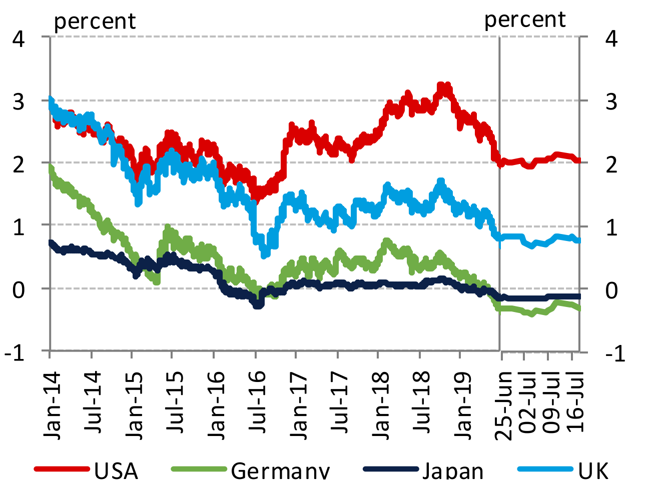
Source: Bloomberg

Global investor sentiment slightly improved since the previous interest rate decision. During the period under review, the VIX index fell from 16 percent below 14 percent, and global bond market trends also reflected a decrease in risk aversion. In parallel with the improvement in global sentiment, the MOVE index, measuring the volatility of the US bond market, decreased by 12 basis points and the emerging market EMBI Global spread registered a fall of 13 basis points in total, during the period under review (Chart 11).

As a result of the communication by the Governor of the European Central Bank after the ECB's previous interest rate decision (18 June), the market priced an interest rate cut already for the fourth quarter of 2019. Since the speech of Mario Draghi, **and in connection with the appointment of the new ECB Governor and the decelerating economic processes, the probability of an interest rate cut rose further according to the market pricing.** Based on the probabilities derived from the future yield curve and the market pricings, **at present the market prices a cut of 10 basis points for autumn 2019.** As regards Fed, markets price the reduction of the key interest rate's target band (by 25 basis points) to 2-2.25 percent earlier, i.e. to the rate setting meeting in July.

In accordance with the decline in the risk averse sentiment, both the developed and emerging market stock exchange indices typically rose during the period under review. The European index and the composite MSCI index measuring the performance of the emerging market rose by almost 1 percent since the last interest rate decision, while the US stock exchange indices registered an increase of 2-3 percent.

Chart 12: Yields on developed market long-term bonds



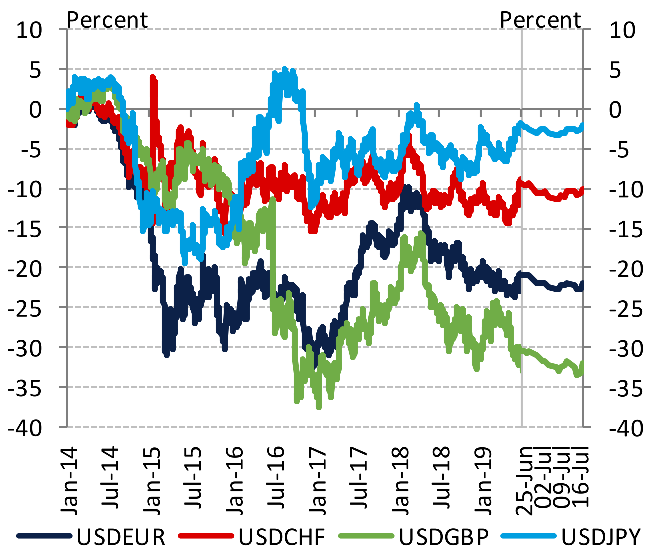
Source: Bloomberg

Yields on developed market long-term government securities moderately rose, while emerging market long-term yields typically decreased. On the developed markets, the US and German long-term yield rose by 6 and 3 basis points, respectively, while the Japanese one was up by 2 basis points. The US ten-year yield was 2.05 percent, while the German and Japanese yields remained below 0 percent (Chart 12). Emerging bond markets were mostly characterised by moderately decreasing yields, except for

Turkey and Argentine, where ten-year yields registered a rise. On the whole, the emerging market EMBI Global spread closed the period with a decrease compared to its level registered at the previous interest rate decision.

The dollar appreciated against most of the other developed currencies. During the period under review, the dollar showed gradual and moderate strengthening against developed currencies. It appreciated against the euro and the Swiss franc to almost the same degree, i.e. by 1.2 and 1.3 percent, and against the Japanese yen by 0.7 percent. The uncertainty around Brexit weakened the British currency further; the British pound depreciated against the dollar by 2 percent (Chart 13).

Chart 13: Developed market FX exchange rates



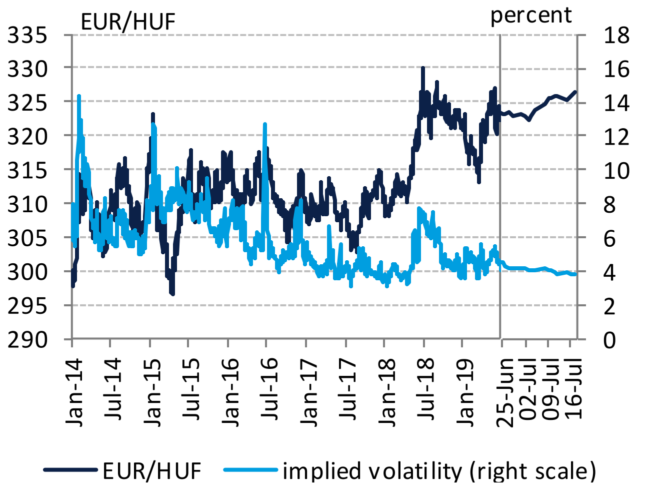
Note: Positive values indicate the strengthening of the variable (second) currency.
Source: Reuters

The exchange rate of the Turkish lira depreciated against the US dollar by almost 2 percent during the last one month. Turkish President Erdogan dismissed central bank Governor Murat Cetinkaya, replacing him by Murat Uysal, former Deputy Governor since 2016. Although the replacement of the central bank governor increased the implied volatility of the exchange rate, it still falls short of the value registered in mid-2018 and early 2019. Investors assessed the dismissal of the Governor negatively, since it raises concerns regarding the independence of the central bank, and may project a more aggressive interest rate cut path, since Erdogan criticised the former Governor several times for the high level of interest rates. As a result of these processes, based on the latest Bloomberg survey, economists anticipate a 200 basis point interest rate cut from the present 24 percent on the rate-setting meeting of 25 July, while longer term investor expectations forecast the base rate to decline to 16.7 percent by the end of 2020. However, the exchange rate of the Turkish lira may be key to the future developments in inflation and interest rate expectations.

2.2. Developments in domestic money market indicators

During the period under review, the forint depreciated against the euro. The 3-month BUBOR rose by 2 basis points to 0.26 percent. There was a smaller decline on the short section of the government securities yield curve and a larger one on the long section thereof, and thus the yield curve became flatter. Due to strong demand at the auction of long-term government securities, the Government Debt Management Agency increased the announced volume several times.

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



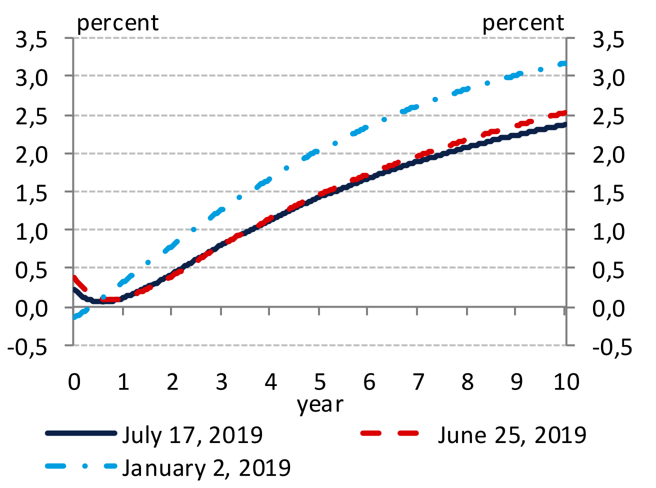
Source: Bloomberg

Since the interest rate decision in June, the forint exchange rate against the euro depreciated from 323 to 327 (Chart 14). On the first two weeks after the interest rate decision the forint exchange rate essentially remained unchanged; the depreciation occurred in the second half of the period under review. During the month, the forint depreciated to a larger degree than the currencies of the region. The Polish zloty, the Czech koruna and the Romania leu depreciated against the euro by 0.2-0.5 percent on the whole during the last one month.

The 3-month BUBOR, relevant for the monetary policy transmission, rose by 2 basis points, and thus it stood at 26 basis points at the end of the period.

The short section of the government yield curve slightly shifted downward, its middle section remained essentially unchanged, while long-term yields also declined. The short section of the yield curve was characterised by a fall of 5-8 basis points, while the long section registered a decline of 15-20 basis points, and thus the government yield curve became flatter during the period under review (Chart 15).

Chart 15: Shifts in the spot government yield curve



Source: MNB, Reuters

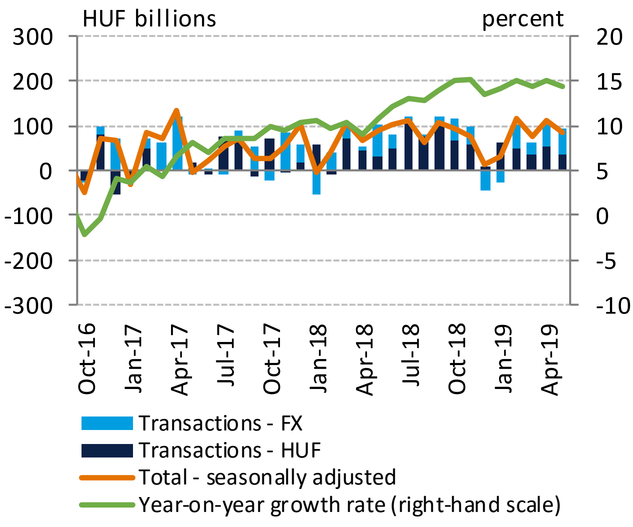
Forint government bond auctions were usually characterised by strong demand; the Government Debt Management Agency reduced the issued volume compared to the announced volume only once due to the moderate demand. Due to strong demand for long-term government securities, the Government Debt Management Agency increased the issued volume. At the auctions of the 3- and 12-month Treasury bills, the Government Debt Management Agency issued the announced volume at each time. The average yield of the 3-month auctions fell to 0 percent by the end of the period, which is lower than the yield of the previous period by 5 basis points. At the 12-month Treasury bill auctions, the average auction yield decreased by 4 basis points to 0.18 percent. In view of the moderate demand at the auction of the 3-year securities, the debt management agency accepted no bid at all. At the same time, the auctions of the longer term government securities attracted strong demand throughout the period, and thus in several cases the Government Debt Management Agency accepted higher volumes than previously announced. The average yield of the 5- and 10-year securities was 1.4 and 2.31 percent, respectively, falling short of the previous period's last average auction yields by 8-10 basis points. The Hungarian 5-year CDS spread fell from 91 basis points to 1 percent during the period under review, and at present it stands at 76 basis points.

Non-residents' forint government securities holdings rose. Accordingly, the portfolio held by non-residents rose by HUF 125 billion to HUF 4,404 billion, while their share was up 0.4 percentage point, and thus at the end of the period it was close to 24.3 percent of the market holding.

3. Trends in lending

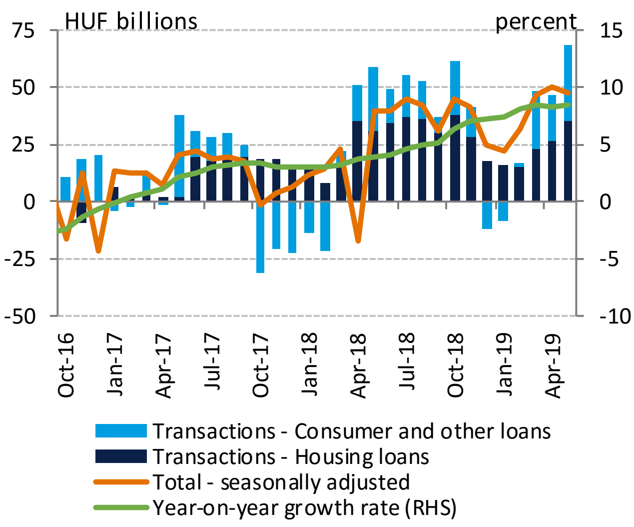
In May, corporate loans outstanding of credit institutions rose by HUF 95 billion as a result of transactions. Household loans outstanding of the credit institutions rose by HUF 68 billion due to transactions, and thus they registered an annual increase of 8.4 percent.

Chart 16: Net borrowing by non-financial corporations



Source: MNB

Chart 17: Net borrowing by households

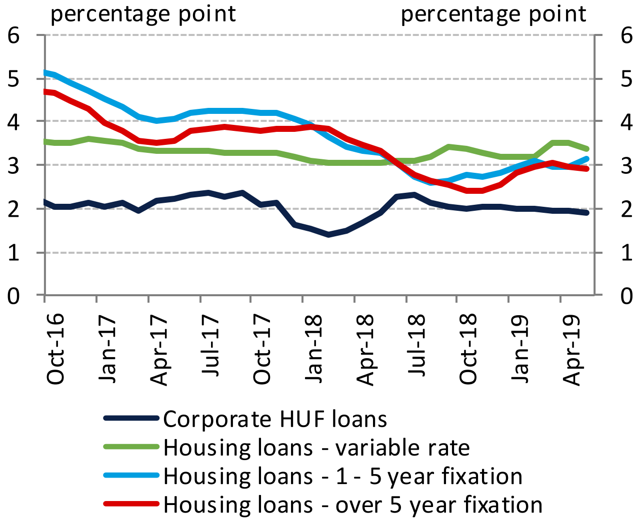


Source: MNB

In May, corporate loans outstanding of credit institutions rose by HUF 95 billion due to transactions (Chart 16). In a breakdown by currency, forint loans and foreign currency loans increased by HUF 33 billion and HUF 62 billion, respectively. Following a moderate slowdown, the annual growth rate of corporate lending amounted to 14.5 percent in May. Excluding money market transactions, the volume of new loans declined to HUF 141 billion during the month, which was primarily attributable to the fact that the individual, large-amount – exceeding HUF 5 billion – new contracts, which in the past period represented a considerable volume, failed to materialise in May.

Household loans outstanding vis-á-vis credit institutions expanded by HUF 68 billion as a result of transactions, and thus they registered an annual increase of 8.4 percent (Chart 17). The volume of new contracts concluded during the month amounted to HUF 179 billion. New loans were still dominated by housing loans (HUF 87 billion) and personal loans (HUF 56 billion). Banks essentially no longer conclude contracts for variable-rate housing loans, and loans with interest rate fixed for over 5 years accounted for 74 percent of new loans during the month. The headway of the Certified Consumer-friendly Housing Loans is undiminished; 64 percent of the housing loan contracts with interest rate fixed for at least 5 years were 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 variable-rate housing loans or ones with up to 1-year rate fixation, APR-based spread over the 3-month BUBOR, while in the case of housing loans fixed for a period longer than one year, the APR-based spread over the corresponding IRS.
Source: MNB

The **smoothed interest rate spread of forint corporate loans** was 1.89 percent in May 2019, representing a decrease of 7 percentage points compared to the previous month (Chart 18). **Following a decline of 10 basis points, the average smoothed interest rate spread on variable rate housing loans calculated on the basis of the annual percentage rate of charge (APR)** amounted to 3.39 percentage points in May. For loans with up to 5 years initial fixation, this value was 3.13 percentage points, while for loans with an interest rate period over 5 years, it stood at 2.91 percentage points in May. **The average spread on fixed-rate loans is still lower than that on variable-rate loans.**