MACROECONOMIC AND

FINANCIAL MARKET DEVELOPMENTS

BACKGROUND MATERIAL

TO THE ABRIDGED MINUTES OF THE

MONETARY COUNCIL MEETING

OF 25 JUNE 2019

June

2019

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The background material 'Macroeconomic and financial market developments' is based on information available until 20 June 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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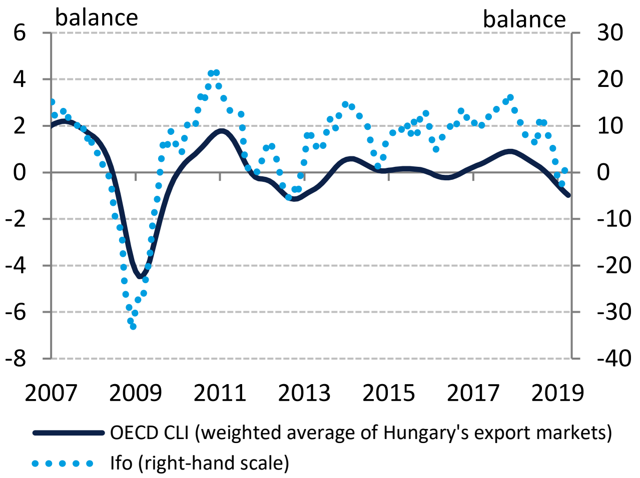
1. Macroeconomic developments

1.1. Global macroeconomic environment

In the first quarter of 2019, both GDP growth in the United States and economic growth in the euro area accelerated quarter on quarter. The trade war between the USA and China remains a major risk factor; at the beginning of May, the leaders of the two countries announced additional customs measures. The incoming actual data paint a more favourable picture of the European real economy trends over the short term; at the same time downside risks have strengthened in the longer run. Growth of the CEE region remains substantially stronger than in the 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 picked up. In the first quarter of 2019, the US economy rose by 3.2 percent and 0.8 percent on an annual and quarterly basis, respectively. The recovery was mainly driven by the increase in state government consumption and 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 relating to the trade policy tensions play an increasingly prominent role in the fears related to the deceleration.** Due to the major role of the United States in global imports, the potential tightening of the customs measures may have a significant effect on global economy growth. The trade talks between the USA and China have yielded no result for the time being. At the beginning of May, the leaders of the two countries announced additional customs measures (the customs tariff of 10 percent rose to 25 percent), and the US government held out the prospect of imposing customs duties, in the amount of USD 300 billion, on additional Chinese import goods (as a result of which the total product turnover from China to the USA would be subject to customs duty). According to IMF's estimate, if the customs duty of all products received in the USA from China rose to 25 percent, the **average annual economic growth of the USA and China would slow down by 0.3-0.6 and 0.5-1.5 percentage points, respectively**.

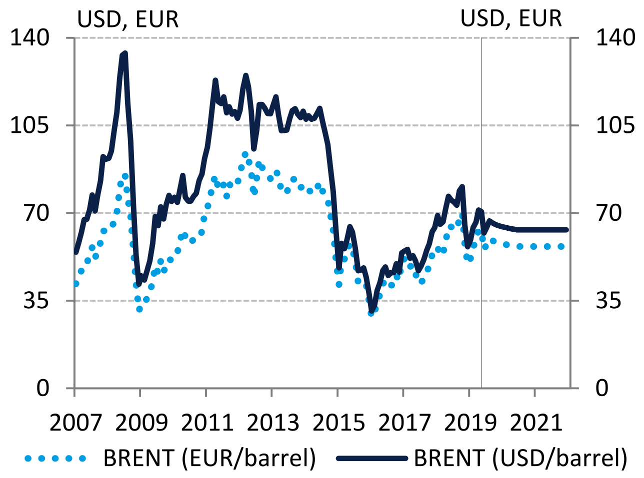
Economic growth in the **euro area** accelerated moderately in the first quarter. **The growth calculated on year-on-year and quarter-on-quarter basis was 1.2 and 0.4 percent, respectively. The economic performance of Germany,** Hungary's key trading partner, **rose by 0.4 percent on a quarterly basis, following the slowdown in the last 2 quarters.** The growth was primarily supported by construction and machinery investments, as well as by households' consumption. Germany's industrial production, similarly to the previous months, declined further in April on an annual basis, resulting from the performance of a wide range of subsectors. New orders of the German industry also decreased year on year. On the other hand, it points to recovery that on a monthly basis new orders of the industry moderately rose both in March and April. In line with the poor performance of the industry, exports declined in April; however, the decline was mostly attributable to the high base of last year. **Despite the favourable GDP data registered in the first quarter, expectations with regard to the German economy's performance this year continue to be unfavourable.** The Ifo index, capturing the outlooks of the German economy somewhat adjusted in May, but it is still close to its trough (Chart 1). **The impact of the German industrial trends on Hungary's prospects is qualified by the fact that in the past months we witnessed the detachment of the Central European and German industrial production.**

In the 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 not able to support growth repeatedly; it reduced GDP growth by 0.3 percentage point. **The performance of the Italian economy continued to stagnate,** although the first quarter of this year showed a moderate growth. 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. As regards the region as a whole, domestic demand acts as the main driver of growth, and in general the region is characterised by separation from the German cyclical developments.

Growth prospects of the euro area continue to be dominated by downside risks. European growth may be curbed by the deteriorating industrial production observed in the past period, primarily attributable to the trade tensions, the vulnerability of Italy stemming from the high government debt, the indirect effects of the deceleration of

Chart 2: World market prices of Brent crude oil



Source: Bloomberg

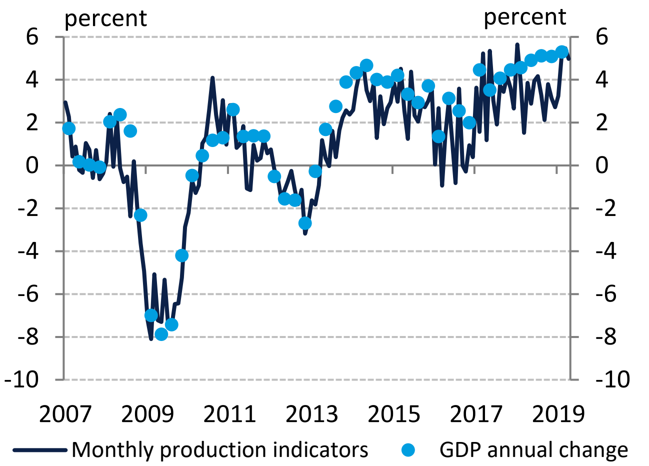
the Chinese economy and the uncertainty resulting from the fragile financial environment on the emerging markets. The uncertainty surrounding the exit of the United Kingdom from the EU continues to represent risk. As a result of the resignation of prime minister Theresa May, the "fallout" of the United Kingdom from the EU (hard Brexit) remains a realistic scenario. The direction of Brexit may depend on the successor to be elected at the end of July. 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 decreased – moderately exceeding the economists' expectations – **in May**, mostly caused by the decline in service price dynamics. Accordingly, inflation stood at 1.2 percent and core inflation at 0.8 percent. The world market price of crude oil, showing substantial volatility in the previous period, fell close to USD 63 (Chart 2). The decrease in the prices observed in past weeks was supported by the global growth risks, as well as by the US oil reserves reaching their two-year high. Due to the expectations related to deteriorating global growth, both the International Energy Agency (IEA) and OPEC reduced their forecast for this year's oil demand, which may keep oil prices close to the current level. At the same time, due to the geopolitical tensions in the Persian Gulf, oil prices are also surrounded by upside risks. World market prices of industrial commodities and unprocessed food declined in May.

1.2. Domestic real economy developments

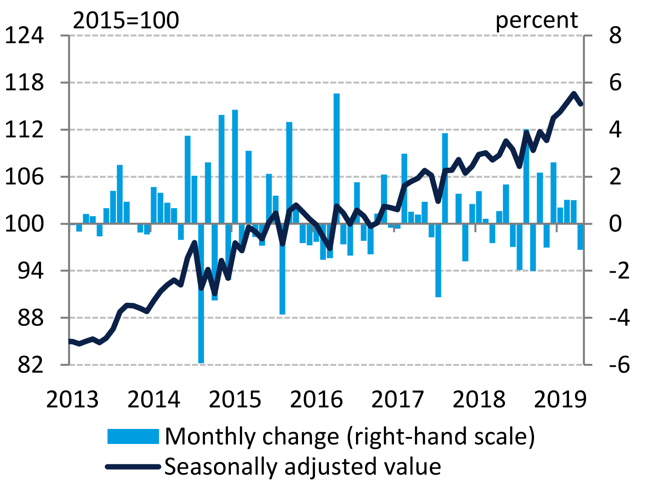
According to the HCSO's data, in the first quarter of 2019, Hungary's gross domestic product rose by 5.3 percent year on year. Buoyant domestic demand continued to support growth. In the period of February to April 2019, the unemployment rate stood at 3.4 percent. The labour market tightness indicator calculated from the ratio of job vacancies and unemployed persons still stands 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

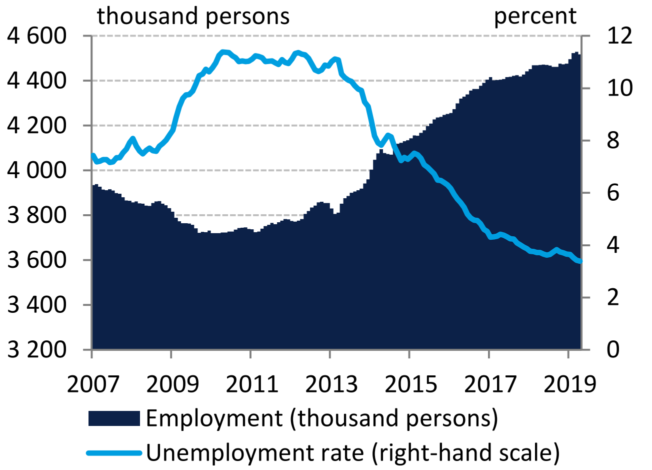
According to HCSO's data release, in the first quarter of 2019, Hungary's gross domestic product rose by 5.3 percent year on year. Based on the seasonally and working-day adjusted data, Hungary's GDP **rose by 1.5 percent quarter on quarter.** According to the currently published data, Hungary is ranked first in the EU member states' growth ranking in year-on-year terms. From the production 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, economic growth was supported to the greatest degree by the dynamic rise in internal demand factors, i.e. consumption and investment.

In April 2019, **industrial output was up 6.3 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; the **output of vehicle manufacturing – representing a considerable weight – increased,** the manufacture of the electronic products moderately declined, while food and chemical industry made positive contribution to industrial growth.

Expressed in euro terms, the value of exports was up by 3.6 percent, while that of imports rose by 7 percent, year on year in April 2019, while trade surplus decreased by EUR 255 million. In March 2019, the terms of trade deteriorated by 0.4 percent, caused by the rise in the relative price of mineral fuels and chemical goods.

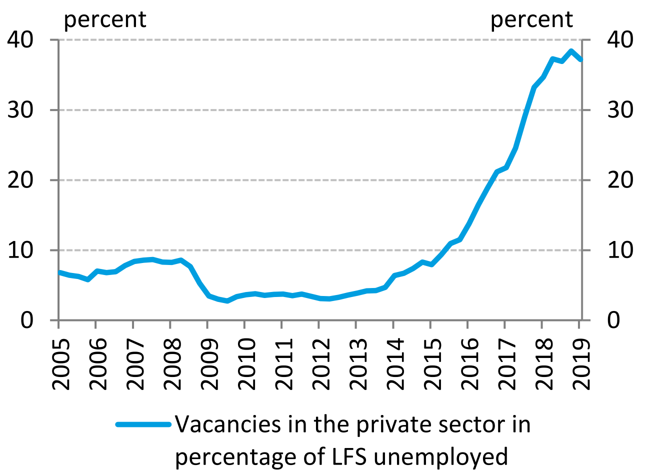
In April 2019, the volume of construction output was up by 40.1 percent year on year. Output increased both in the number of buildings and other structures. The growth in the construction of buildings was attributable to the construction of industrial, residential and office buildings. Due to the government investments, primarily to infrastructure developments (road, railway), construction of other buildings increased further. The **volume of new contracts decreased by 4.4 percent** year on year; within that, the number of contracts for buildings increased by 19 percent, while it decreased by 19 percent for other structures compared to the previous year. The month-end volume of construction companies' contract portfolio rose

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

by 50.3 percent for buildings, while it decreased by 19.3 percent for other structures.

In April, **retail sales volume was up 7.1 percent year on year, based on the data adjusted for the calendar effect**. According to the seasonally adjusted data, retail sales volume rose further compared to the previous month. As regards the structure of retail sales, turnover continued to rise in a wide range of products. 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, furniture and technical articles, as well as of the mail order shops. In addition, fuels sales also rose by 5.5 percent. In April the turnover of food stores and groceries, representing a considerable weight, showed major increase compared to the previous months – 4.7 percent after adjustment for the calendar effect – year on year.

1.2.2. Employment

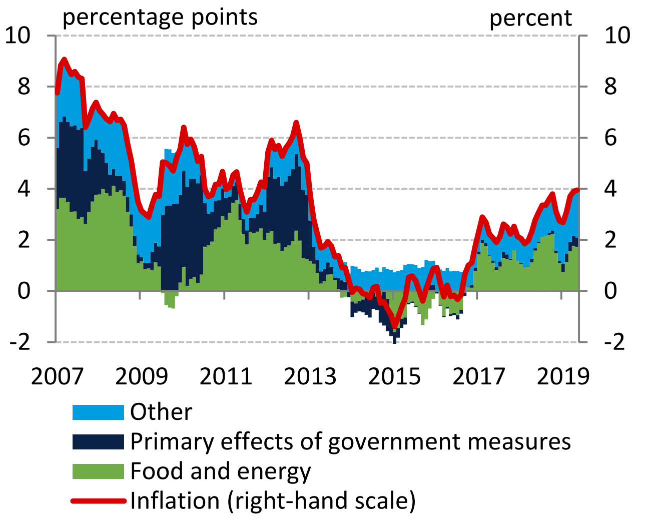
According to the (seasonally adjusted) data of the Labour Force Survey, in the period of February to April 2019, both the labour force participation rate and the number of people in employment moderately decreased. The number of people in public employment declined further, while the number of people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

In the first quarter of 2019, based on the number of vacancies, corporate labour demand decreased both in manufacturing and 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

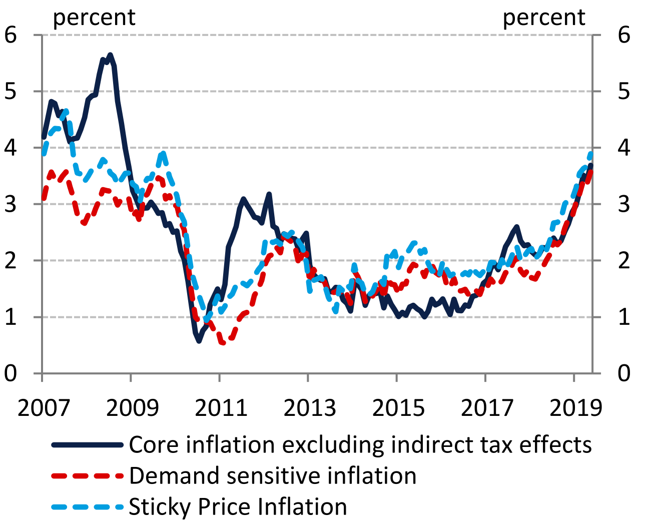
In May 2019, year-on-year inflation was 3.9 percent. Core inflation stood at 4.0 percent, while core inflation excluding indirect taxes was 3.7 percent. Underlying inflation indicators rose compared to the previous month. In the first quarter of 2019, gross average wage in the private sector rose by 11.8 percent year on year. The wage dynamics, substantially exceeding the 8 percent rise in the minimum wage and the guaranteed wage minimum, may primarily be attributable to the tight labour market conditions determining the underlying wage setting trend.

Chart 7: Decomposition of inflation



Source: MNB calculation based on HCSO data

Chart 8: Measures of underlying inflation indicators



Source: MNB calculation based on HCSO data

1.3.1. Wage setting

In the first quarter of 2019, gross average wage in the private sector rose by 11.8 percent year on year. In January the rise in the regular average wage exceeded the usual seasonality and was up by 4 percent on a monthly basis. In March, the monthly increase in regular average wage was slightly lower than the usual seasonality. The overall conclusion that may be drawn from the above is that although the typical seasonality of wage setting remained unchanged, i.e. companies typically revised the wages in March this year as well, compared to the previous years, many companies raised wages already at the beginning of the year, in January. The wage dynamics, substantially exceeding the 8 percent rise in the minimum wage and the guaranteed wage minimum, may primarily be attributable to the tight labour market conditions determining the underlying wage setting trend. With the tightening of the fringe benefit system this year, in the first quarter the ratio of other earned incomes declined by 0.8 percentage point year on year; companies may have offset the lost income by raising the wages.

1.3.2. Inflation developments

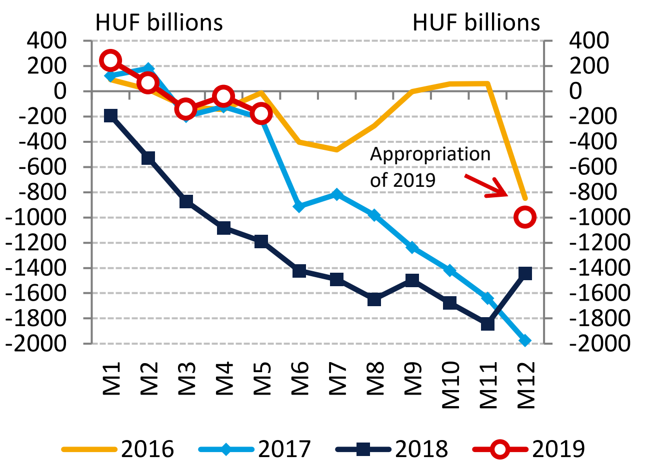
In May 2019, year-on-year inflation was 3.9 percent (Chart 7). **Core inflation stood at 4.0 percent, while core inflation excluding indirect taxes was 3.7 percent.** Inflation did not change, while **core inflation and core inflation excluding indirect taxes rose by 0.3 percentage point** compared to the previous month. The rise in core inflation was caused by the increase in the prices of market services and processed food.

The rest of the 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 April 2019, agricultural producer prices rose by 6.6 percent in annual terms, while the domestic sales prices of the consumer goods sectors increased by 4.9 percent.

1.4. Fiscal developments

In May 2019, the central sub-sector of the general government closed with a deficit of HUF 137 billion. In May 2019, the revenues and expenditures of the central sub-sector exceeded the year-on-year figures by HUF 117 billion and HUF 148 billion, respectively.

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



Source: Budget Act of 2019, Hungarian State Treasury

In May 2019, the central sub-sector of the general government closed with a deficit of HUF 137 billion, and thus the deficit accumulated in the first five months rose to HUF 176 billion, which is lower than the cash deficit registered in the first five months of the previous years (Chart 9).

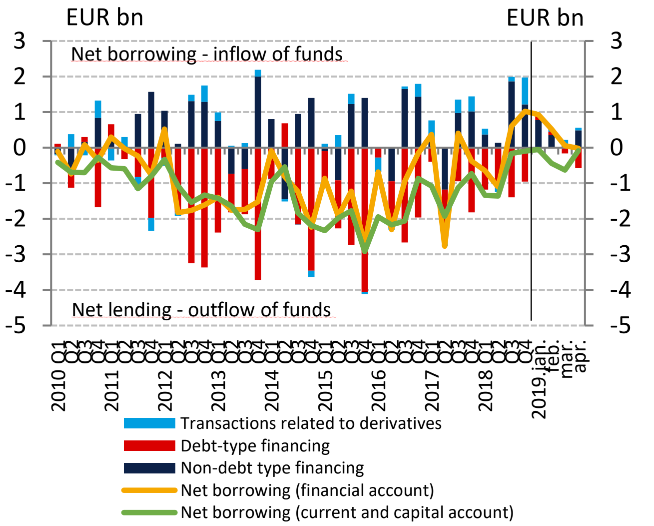
In May 2019, the **revenues of the central sub-sector** were up by HUF 117 billion year on year, which was mostly attributable to the rise in consumption tax and labour tax revenues. Gross revenues from value added taxes rose by 14 percent, while revenues related to wages and other earnings were up by 12 percent year on year.

In May 2019, the **expenditures of the central sub-sector** were up by HUF 148 billion year on year due to the higher expenditures of the central budgetary organisations, and of the normative and special subsidies. The increase in the expenditures of the budgetary organisations is reflected by the institutional expenditures, which in May exceeded the monthly average expenditures of January to April by HUF 100 billion.

1.5. External balance developments

Compared to March, both net lending and the current account decreased. According to the financial account data, the outflow of funds was realised under a growth in net FDI and a more substantial decline 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 April, net lending of the economy amounted to EUR 91 million. Compared to March, both net lending and the current account decreased, which was primarily attributable to the decrease in trade surplus, and to a lesser degree, to the lower absorption of EU transfers compared to March, while the income balance has not changed substantially (Chart 10).

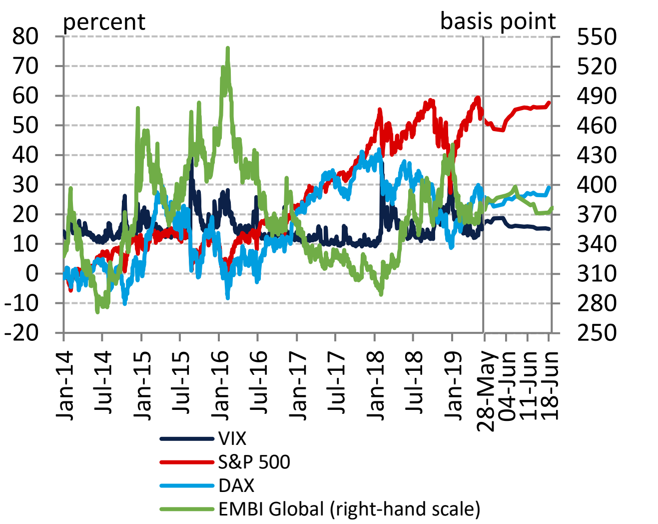
According to the financial account data, the outflow of funds was realised under a growth in net FDI and a more substantial decline in net external debt. The inflow of net foreign direct investments of almost EUR 500 million was primarily attributable to the reinvested earnings of non-resident corporations. The decrease of almost EUR 600 million in net external debt was related to the private sector, while the net external debt of the general government slightly increased.

2. Financial markets

2.1. International financial markets

Since the previous interest rate decision, global market sentiment varied, but on the whole it improved slightly, which was mostly caused by the communication of the world's major central banks suggesting an accommodating monetary policy. According to the market expectations, the ECB may cut the interest rate this autumn, while the Fed may do so already in July. The US and European stock exchange indices substantially increased, while the Asian ones recorded a moderate decline. The yields on the developed and emerging market long-term government securities also materially declined, while the German ten-year yield fell to its historic low. During the last one-month oil prices declined, which was mostly caused by the anxieties related to demand shortage.

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



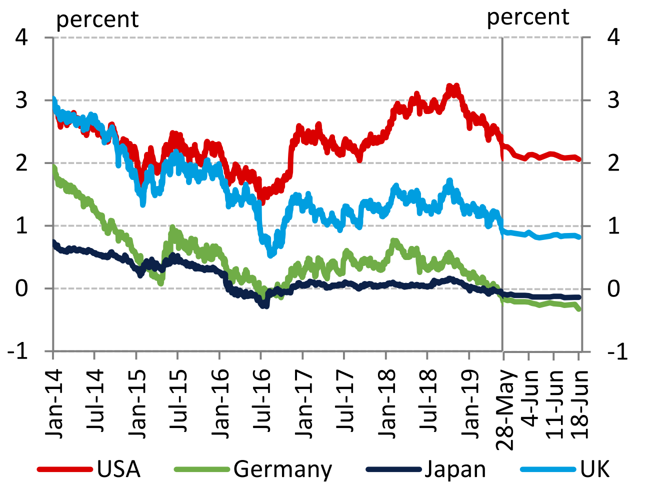
Source: Bloomberg

Global investor sentiment varied since the previous interest rate decision, but on the whole it moderately improved. The continued unfavourable macroeconomic prospects pointed to a rise in aversion to risk; at the same time, in the second half of the period under review, the communication by the world's major central banks suggesting a monetary easing resulted in rising risk appetite. During the period under review, the VIX index fell from 18 percent to 15 percent. Global bond market trends first reflected a growth in aversion to risk; later on, the shift by the world's major central banks toward a more accommodating monetary policy, increased the demand also for the riskier bonds. Although the MOVE index, measuring the volatility of the US bond market, rose by 14 basis points, the emerging market EMBI Global spread registered a fall of 15 basis points during the period under review (Chart 11).

Based on the market expectations, the ECB may cut the interest rate as early as this autumn, which is a major departure compared to the previous pricings. Due to the unfavourable macroeconomic outlooks and the declining inflation expectations, at the beginning of the period the market pricings gradually shifted toward a more accommodating monetary policy. **However, the material change in the market expectations was attributable to ECB Governor Mario Draghi's Sintra speech.** At the end of May the market expected the present interest rate level to hold on until autumn 2021, and thereafter it anticipated an interest rates hike by the European Central Bank. However, based on the present pricing, the ECB may reduce its key policy rate by 10 basis points as early as this autumn, which may be followed by another 10 basis points cut next year.

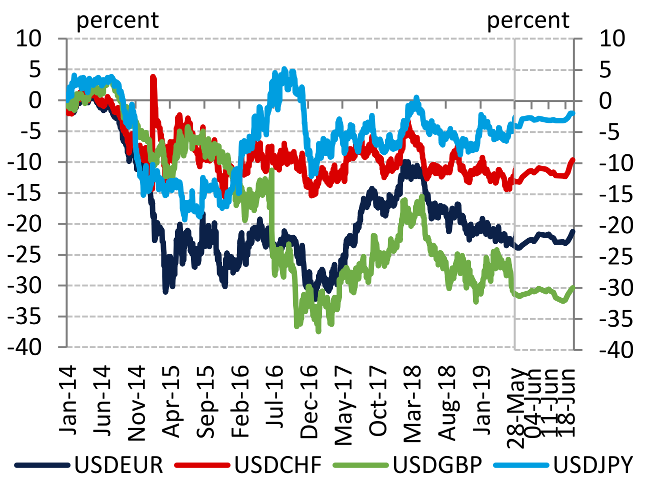
In June, the Fed policy makers did not change the key interest rate band of 2.25-2.5 percent; however, based on the policy makers' interest forecast (dot plot) many expect an interest rate cut. Based on the market pricing, there is a high probability of an interest rate cut in July, but the degree

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

thereof is still questionable. The majority of market participants expect an interest rate cut of 25 basis points, but some actors anticipate a reduction of 50 basis points.

In accordance with the favourable sentiment, the developed and emerging market stock exchange indices mostly rose during the period under review. The key US and European equity indices rose by 3-4 percent since the last interest rate decision. At the same time, the Asian equity indices registered a moderate, 1-1.5 percent, decline. The composite MSCI indices measuring the performance of the developed and emerging market performance both rose by 3 percent.

The developed and emerging market long-term government securities' yields substantially decreased (Chart 12). On the developed markets, the US, German and Japanese long-term yields fell by 35, 22 and 10 basis points, respectively. **Consequently, the German long-term yield fell to its historic low, i.e. below -0.3 percent**, the US ten-year yield declined close to 2.0 percent, while the Japanese yield was around -0.15 percent. Emerging bond markets were also characterised mostly by decreasing yields.

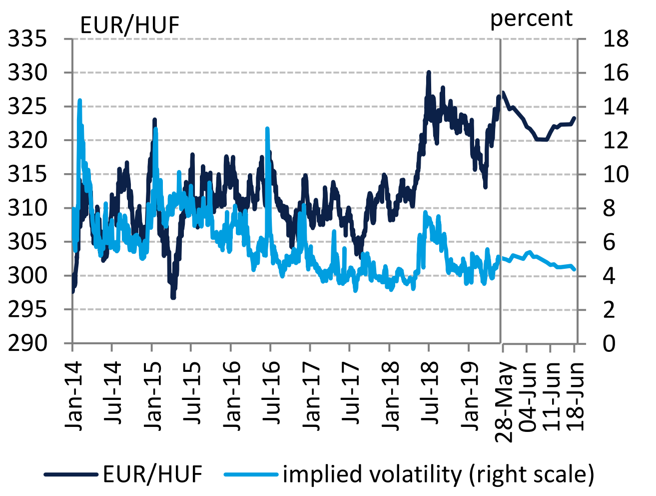
The dollar exchange rate showed mixed performance against the other developed currencies. During the period under review, it **depreciated against the euro**, the Japanese yen and the Swiss franc by roughly **0.3 percent**, 0.9 percent and 0.4 percent, respectively. The uncertainty around Brexit once again weakened the British currency, and consequently, the British pound depreciated against the dollar by 0.8 percent (Chart 13).

During the last one month, oil prices substantially declined. Oil prices rose until the end of April from their more than two-year low recorded at the end of December, which was followed by a decline in the past two months. **During the last one month the price of Brent and WTI fell by 11 and 8 percent, respectively.** During the month, the US sanctions against Iran and the attacks on the oil tankers caused oil prices to rise. At the same time, the demand concerns – also reflected by the reduction of the International Energy Agency's (IEA) estimate for the growth in global oil demand – entailed stronger oil price reducing effects, overall.

2.2. Developments in domestic money market indicators

During the period under review, the forint appreciated against the euro. The 3-month BUBOR rose by 5 basis points to 25 basis points. The short section of the government securities yield curve shifted upwards, while the middle and long section thereof shifted downwards.

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



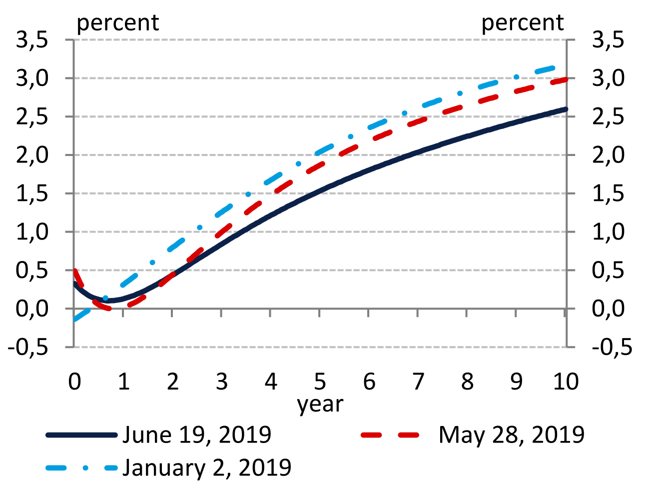
Source: Bloomberg

The forint exchange rate against the euro strengthened from 327 to 323 during the period under review, and thus it appreciated by 1.2 percent since the May interest rate decision (Chart 14). After the interest rate decision, it strengthened close to the level of 320, while during the last one week it adjusted to exceed 323. During the month, the forint appreciated to a slightly greater degree than the currencies of the region, since the Polish zloty, the Czech koruna and the Romanian leu appreciated against the euro by 0.8-1.0 percent in total.

The short section of the government yield curve slightly rose, while – similarly to the interbank yield curve – the medium and long-term yields substantially declined (Chart 15). The short section of the yield curve was characterised by a rise of 5-10 basis points, while the middle and long sections registered a fall of 5-35 and 35-40 basis points, respectively, and as a result, the government yield curve became flatter during the period under review.

The 3-month BUBOR, relevant for the monetary policy transmission, rose by 5 basis points, and it stood at 25 percent at the end of the period.

Chart 15: Shifts in the spot government yield curve



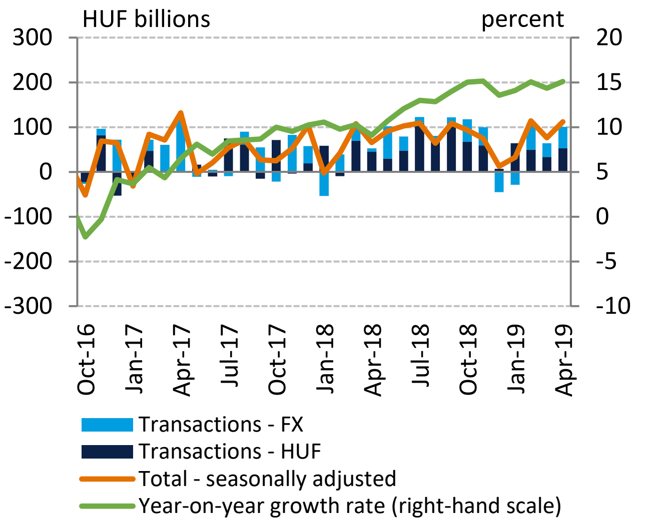
Source: MNB, Reuters

At the forint government bond auctions, demand for shorter term securities was usually strong; the Government Debt Management Agency reduced the issued volume compared to the announced volume only once due to the moderate demand. Demand for long-term securities was strong at all auctions; the Government Debt Management Agency increased the announced volume several times. At the auctions of the 12-month Treasury bills the volume of government securities sold fell short of the announced volume on one occasion, while in the rest of the cases demand was strong both for the 3-month and 12-month Treasury bills. The average yield of the 3-month auctions fell to 0.05 percent by the end of the period, which is lower than the yield of the previous period by 3 basis points. At the 12-month Treasury bill auctions, the average auction yield rose by 2 basis points to 0.22 percent. At the same time, the auctions of the longer-term government securities attracted strong demand throughout the period, and therefore, the Government Debt Management Agency accepted higher volumes, in several cases, than previously announced. The average yield of the 3- and 5-year securities was 1.01 and 1.73 percent, respectively, falling short of the previous period's last average auction yields by 25-30 basis points.

3. Trends in lending

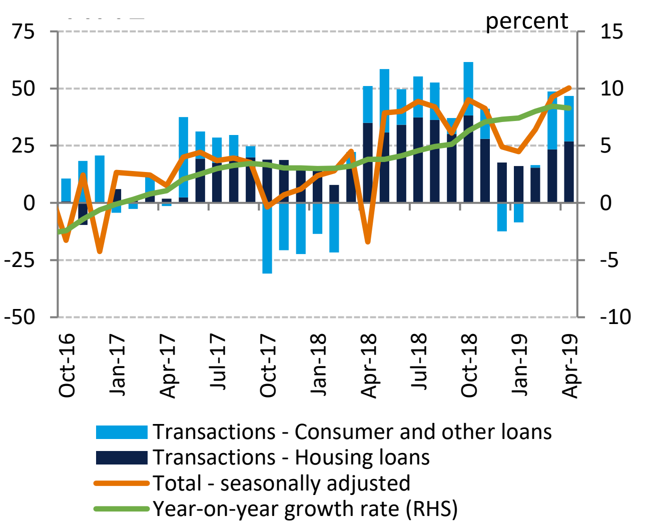
In April, the outstanding corporate loans of credit institutions rose by HUF 100 billion due to transactions. The outstanding loans of the credit institutions to households rose by HUF 47 billion, and they registered an 8.3 percent year-on-year growth.

Chart 16: Net borrowing by non-financial corporations



Source: MNB

Chart 17: Net borrowing by households

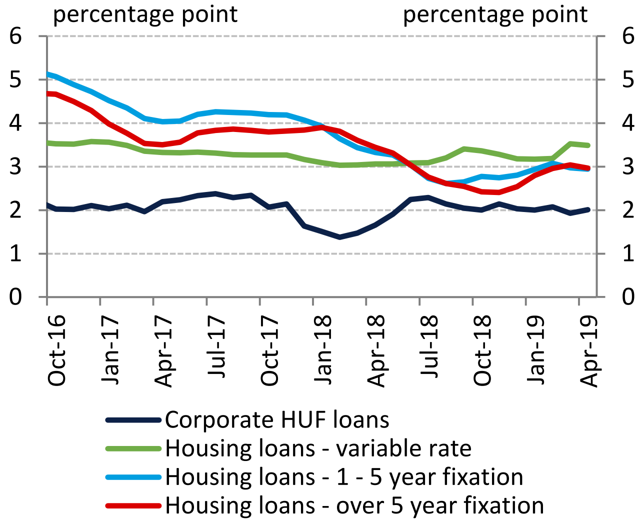


Source: MNB

In April the outstanding corporate loans of credit institutions rose by HUF 100 billion due to transactions (Chart 16). In a breakdown by currency, forint loans and foreign currency loans increased by HUF 52 billion and HUF 48 billion, respectively. The annual growth rate of corporate lending rose to 15.1 percent in April. Excluding money market transactions, the volume of new loans amounted to HUF 234 billion during the month.

Credit institutions' lending to households rose by HUF 47 billion due to transactions, and thus they registered an 8.3 percent year-on-year growth (Chart 17). The value of new contracts concluded during the month amounted to HUF 165 billion. New loans were still dominated by housing loans (HUF 83 billion) and personal loans (HUF 49 billion). The Certified Consumer-friendly Housing Loan products make a substantial contribution to the growth in lending for housing purposes in a sounder structure; by April, the placement of loans with interest rate fixed for less than 1 year practically ceased, while of those fixed for more than 5 years rose to 73 percent.

Chart 18: Development of corporate and household credit spreads



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

Source: MNB

The smoothed interest rate spread of forint corporate loans was 2.01 percent in April 2019, representing a moderate increase compared to the previous month (Chart 18). The average smoothed interest rate spread on variable rate housing loans calculated on the basis of the annual percentage rate (APR) rose by 31 basis points compared to the end of last year, to 3.49 percentage points. In the case of loans the interest rate of which is fixed for 5 years at the most, this value rose by 14 basis points to 2.94 percentage points, while in the case of loans fixed for more than 5 years, it was increased by 43 basis points to 2.97 percentage points, but the average spread on fixed-rate loans is still below that on the variable-rate loans.