MACROECONOMIC AND

FINANCIAL MARKET DEVELOPMENTS

BACKGROUND MATERIAL

TO THE ABRIDGED MINUTES OF THE

MONETARY COUNCIL MEETING

OF 28 MAY 2019

May

2019

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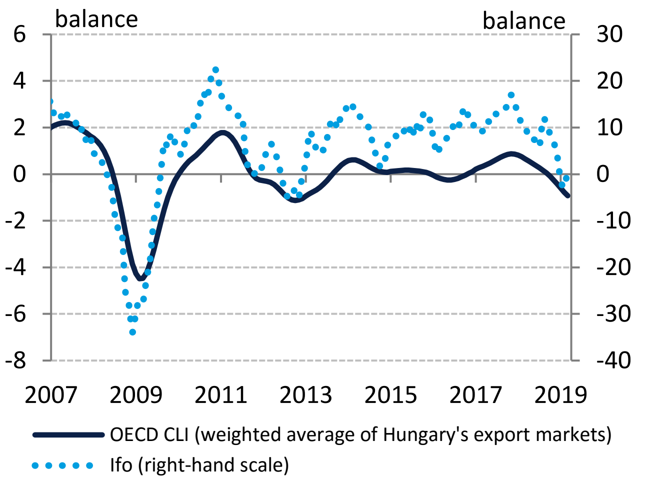
1. Macroeconomic developments

1.1. Global macroeconomic environment

International macroeconomic developments showed a mixed picture. In the first quarter of 2019, GDP growth in the United States was brisker, while economic growth in the euro area continued, in annual terms, at the same rate as in the previous quarter. The incoming actual data paint a more favourable picture of the European real economy trends over the short term. Growth in the CEE region remains 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, while international macroeconomic developments were mixed. In the first quarter of 2019, the US economy rose by 3.2 percent in annual terms. Quarterly growth was 0.8 percent, which indicates accelerating growth in the US economy. 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 anxieties concerning trade policy tensions play an increasingly prominent role in the fears related to deceleration.** Due to the major share of the United States within global imports, the potential tightening of the customs measures may have a significant effect on global economy growth.

Due to the delay in the trade talks between the USA and China, the leaders of the two countries announced additional customs measures. As a result, the customs tariff of 10 percent rose to 25 percent. 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 decelerate by 0.3-0.6 and 0.5-1.5 percentage points, respectively.

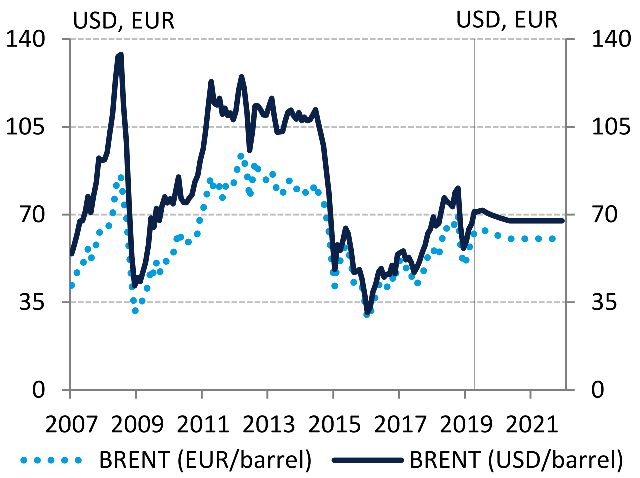
Economic growth in the **euro area** accelerated moderately in the first quarter. **The growth calculated on year-on-year and quarter-on-quarter basis was 1.2 and 0.4 percent, respectively.** (In the last quarter of 2018, GDP rose by 0.2 percent on a quarterly basis.) **The economic performance of Germany,** 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. Similarly to the previous months, Germany's industrial production declined further in March on an annual basis, resulting from the performance of a wide range of subsectors. New orders of the German industry also significantly decreased year on year. On the other hand, it points to recovery that on short base both indices accelerated. Exports rose in line with the moderately improving industrial performance. **Despite the favourable 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 March, 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, contributed to by consumption on the expenditure side. After the positive contribution, registered in the previous two quarters, net exports curbed growth by 0.3 percentage point. The performance of the **Italian** economy continued to stagnate; at the same time, the first quarter of this year showed a moderate rise. 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 4.6 percent, 5.1 percent, 3.8 percent and 2.5 percent, respectively. **As regards the region as a whole, domestic demand acts as the main driver of growth,** and in general – with the exception of the Czech Republic – the region is characterised by separation from the German cyclical developments.

Growth prospects of the euro area continue to be dominated by downside risks. Identifiable downside risks affecting European growth include 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 the Chinese economy and the uncertainty resulting from the fragile financial environment

Chart 2: World market prices of Brent crude oil



Source: Bloomberg

on the emerging markets. In addition to the foregoing, the uncertainty surrounding the exit of the United Kingdom from the EU continues to represent risk. The deterioration of the outlooks is somewhat mitigated by the fact that the probability of a no-deal Brexit – regarded as the worst scenario for euro area growth – has declined. Since the British Parliament has not adopted the draft Brexit deal by the end of May, pursuant to the April agreement between the EU and Great Britain to postpone Brexit, the UK must participate in the European Parliament election. At the same time, the end of October date for Brexit remained in force. As regards the global economic activity, the increase in trade tensions remained the most significant growth risk in the past months.

Underlying inflation measured in the euro area rose – moderately exceeding the economists' expectations – **in April**, caused by the rise in service price dynamics (Easter effect[1]). Accordingly, inflation stood at 1.7 percent and core inflation at 1.3 percent.

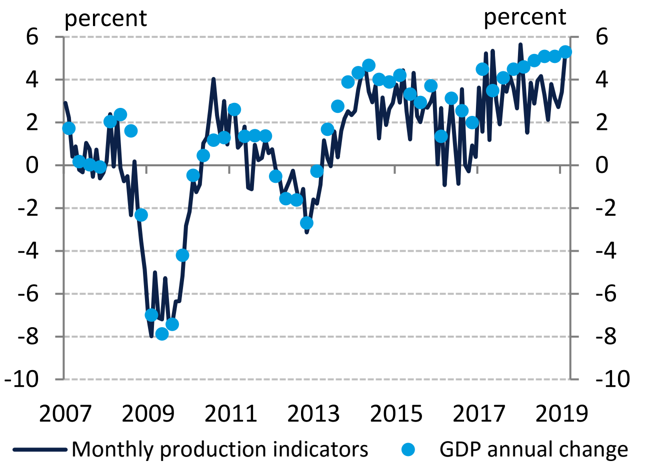
In April, **world market price of oil** rose, under greater volatility, close to USD 75; then in May – as a result of several contrasting effects – moderately declined on the whole (Chart 2). At the end of April, the announcement by US President Donald Trump, according to which after 1 May the USA imposes sanctions on countries buying Iranian oil, pointed to a rise in oil prices. Accordingly, both China and India lost their 6-month exemption from the sanctions lasting since November. Thereafter, the fact that Trump called upon the OPEC countries to increase their oil output to counterbalance the output lost as a result of the sanctions on Iran, reduced prices. OPEC announced that it would not satisfy this request, and thus prices once again started to rise. The US oil reserves, meanwhile reaching their two-year high, were able to mitigate this effect only partially. **World market prices of industrial commodities** moderately increased, while those of **unprocessed food** remained essentially unchanged.

[1] The Easter effect forms part of the calendar effect. This occurs when in two subsequent years Easter (and the preceding shopping period) falls to different months.

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 parallel with the rise in labour force participation rate and employment, the seasonally adjusted unemployment rate fell to 3.4 percent (Chart 5). The labour market tightness indicator calculated from the ratio of job vacancies and unemployed persons remained at a high level.

Chart 3: Monthly production indicators and GDP growth



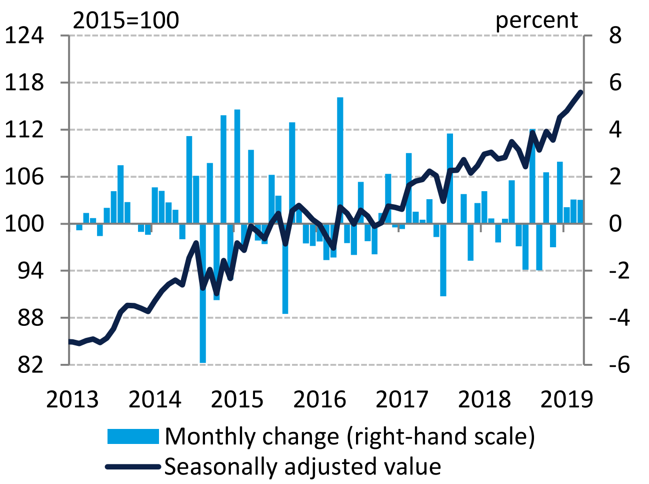
Note: Weighted average of monthly production indicators (industrial output, construction output and retail sales). The weights are derived from regression explaining GDP growth.
Source: MNB calculation based on HCSO data

1.2.1 Economic growth

According to HCSO's 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. 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 contributed positively to growth. 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 March 2019, **industrial output was up 8 percent** year on year, while production **rose by 1.0 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 – substantially rose**; in addition, both the electronics sector and the chemical industry made positive contribution to industrial growth.

Chart 4: Development in industrial production

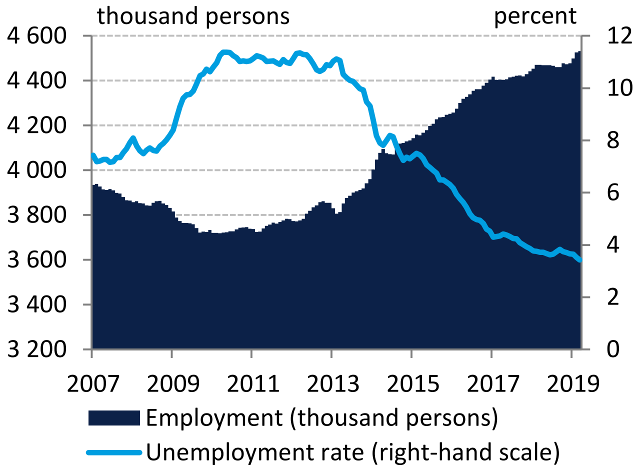


Source: MNB calculation based on HCSO data

Expressed in euro terms, **the value of exports –** in parallel with the industrial production – **was up by 4.9 percent, while that of imports rose by 5.6 percent** year on year in March 2019. Trade surplus declined by EUR 21 million. Export and import prices considerably rose in February even in a historical comparison. In February 2019, the terms of trade deteriorated (decreased by 0.9 percent year on year), caused by the rise in the relative price of mineral fuels and chemical goods.

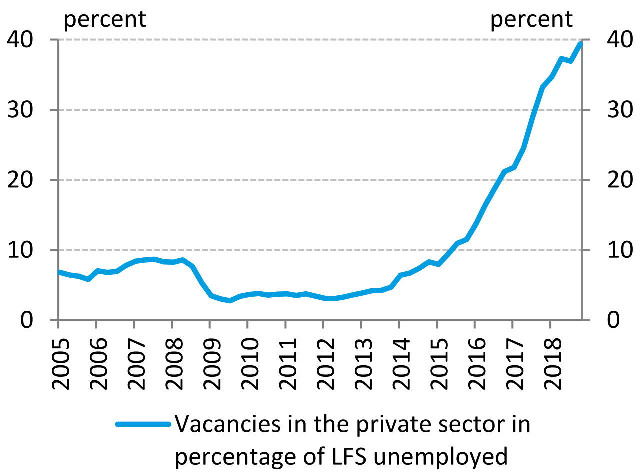
In March 2019, the volume of construction output was up by 67.5 percent year on year. Output increased both in the case of buildings and other structures. In the case of the construction of buildings, the growth in production was attributable to industrial, office and residential buildings. Due to the government investments, primarily to infrastructure developments (road, railway), construction of other buildings increased further. The **volume of new contracts increased** year on year; within that, the number of contracts for buildings significantly increased, while it

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

decreased in the case of other structures compared to the previous year. The month-end volume of construction companies' contract portfolio substantially rose for buildings, while it decreased for other structures.

In March, **retail sales volume was up 5.9 percent year on year, based on the data adjusted for the calendar effect**. Retail sales volume rose slightly compared to the previous month. As regards the structure of retail sales, turnover continued to rise in a wide range of products. The substantial rise in the turnover of non-food consumer durables continued to support growth to a considerable degree; in addition, the turnover of shops selling food products also showed a major increase (Easter effect). In addition, the volume of fuel sales was also outstanding (14.3 percent increase).

1.2.2. Employment

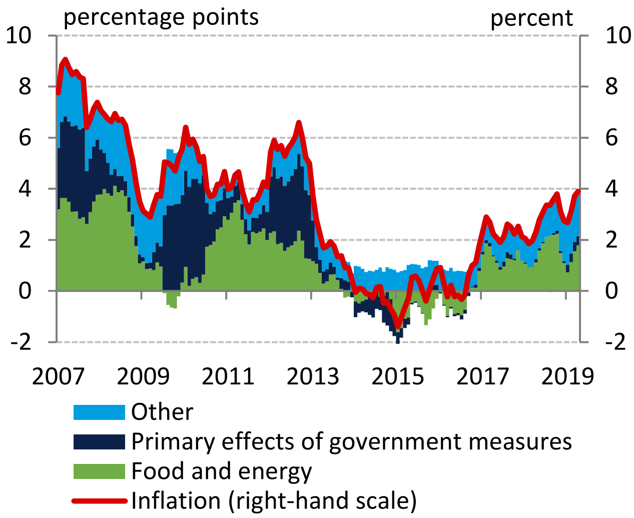
According to the (seasonally adjusted) data of the Labour Force Survey, in the first quarter of 2019, both the labour force participation rate and the number of people in employment rose. The improvement in total employment is primarily attributable to the private sector, while public sector employment also rose moderately. At the same time, the number of people in public employment fell to 121,000. Within the private sector, the market service sector registered a major growth in employment, while employment in manufacturing essentially remained unchanged. The number of people employed abroad was essentially constant, at 109,000. **In parallel with the rise in labour force participation rate and employment, the seasonally adjusted unemployment rate fell to 3.4 percent** (Chart 5).

In the fourth quarter of 2018, based on the number of job vacancies, corporate labour demand remained high in manufacturing, while it moderately rose 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

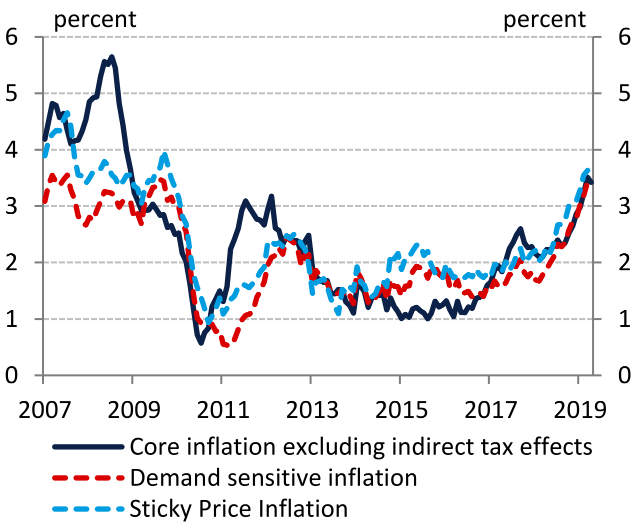
In April 2019, year-on-year inflation was 3.9 percent, core inflation was 3.8 percent, while core inflation excluding indirect taxes stood at 3.4 percent. Underlying inflation indicators essentially remained unchanged compared to the previous month. In February 2019, gross average wage in the private sector rose by 12.1 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 February 2019, gross average wage in the private sector rose by 12.1 percent year on year. The monthly change of the regular average wage was essentially in line with the usual seasonality observed in February; no adjustment for the outstanding growth recorded in January was observed. 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.

1.3.2. Inflation developments

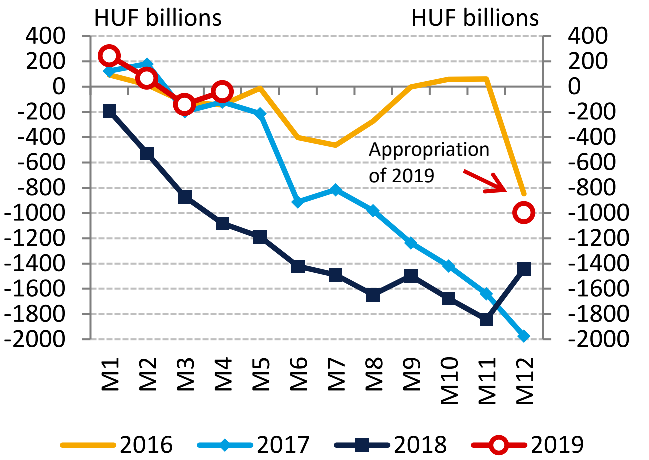
In April 2019, year-on-year inflation was 3.9 percent, while core inflation and core inflation excluding indirect taxes stood at 3.8 and 3.4 percent, respectively (Chart 7). Inflation rose by 0.2 percentage point compared to the previous month, which was primarily caused by the increase in fuel prices. Core inflation did not change, and thus the rise in the indicator, observed for more than six months, stopped.

Core inflation excluding indirect taxes fell by 0.1 percentage point in April, which was primarily caused by the decline in industrial goods, the highly volatile airfares. **The rest of the underlying inflation indicators capturing the more permanent trends** (annual inflation of demand sensitive and sticky price products and services) **essentially remained unchanged** compared to the previous month (Chart 8). In March 2019, agricultural producer prices rose by 7.0 percent in annual terms, while the domestic sales prices of the consumer goods sectors increased by 3.8 percent.

1.4. Fiscal developments

In April 2019, the central sub-sector of the general government closed with a surplus of HUF 103 billion, and thus the deficit accumulated in the first four months dropped to HUF 39 billion. The more moderate deficit compared to the previous year was attributable to both the higher revenues and lower expenditures than those recorded last year.

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



Source: Budget Act of 2019, Hungarian State Treasury

In April 2019, the central sub-sector of the general government closed with a surplus of HUF 103 billion, and thus the deficit accumulated in the first four months dropped to HUF 39 billion, which is lower than the cash deficit registered in the first four months of the previous years (Chart 9). The more moderate deficit compared to the previous year was attributable to both the higher revenues and lower expenditures than those recorded last year.

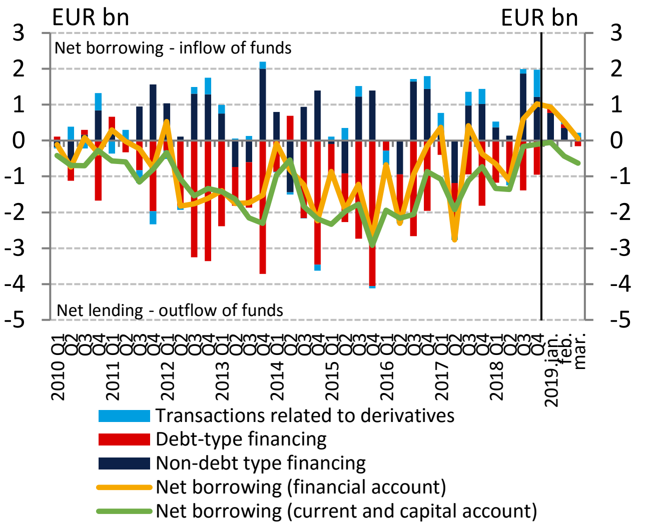
In April 2019, the **revenues of the central sub-sector** were up by HUF 162 billion year on year, which was mostly attributable to the consumption taxes, and to income related to wages and other earnings. Incomes related to wages and other earnings rose by 9.3 percent in April, while gross payments from value added tax were up by 12 percent year on year.

In April, the **expenditures of the central sub-sector** were lower by HUF 150 billion year on year, which was mostly attributable to the lower expenditure of the central budgetary organisations and the more moderate expenses related to EU transfers.

1.5. External balance developments

In March, net lending of the economy and the current account both increased. According to the financial account data, in March there was a minor decrease in the net external debt of the economy, while the rise in net FDI inflow continued.

Chart 10: Structure of net lending (unadjusted transactions)



Note: Positive values indicate net borrowing (inflow of funds), while negative values indicate net lending (outflow of funds).
Source: MNB

In March , the current account surplus of the economy and net lending rose to EUR 208 million and EUR 632 million, respectively. The rise in the current account primarily related to the higher absorption of EU transfers, while the trade surplus moderately decreased and the income balance has not changed substantially.

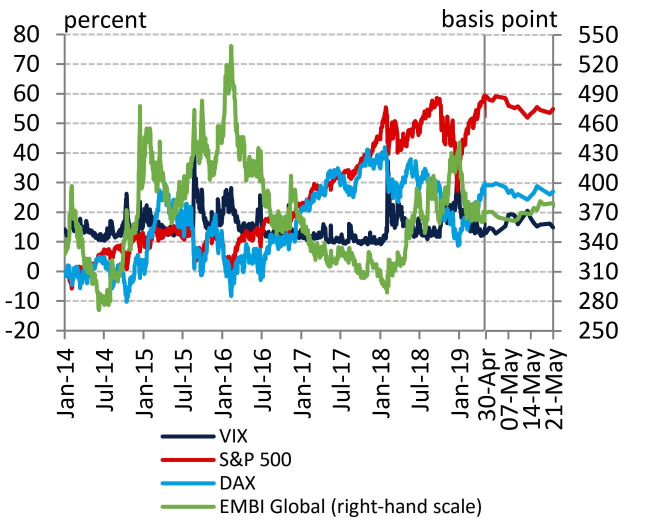
According to the financial account data, net FDI inflow continued, while net external debt moderately decreased. The growth of EUR 74 million in net foreign direct investments was still primarily attributable to the reinvested earnings of non-resident enterprises. The decrease in net external debt is connected to the general government, the impact of which was reduced by the private sector's increasing net external debt (Chart 10).

2. Financial markets

2.1. International financial markets

Since the previous interest rate decision, global market sentiment moderately deteriorated, which was primarily caused by the deepening of the trade tensions. The US and Japanese stock exchange indices substantially decreased, while the European ones recorded a more moderate decline. The yields on the developed market long-term government securities declined and the emerging long-term yields also typically decreased. During the last one month oil prices declined on the whole, which – despite the recent anxieties related to supply shortage – were pushed downward by supply side factors.

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



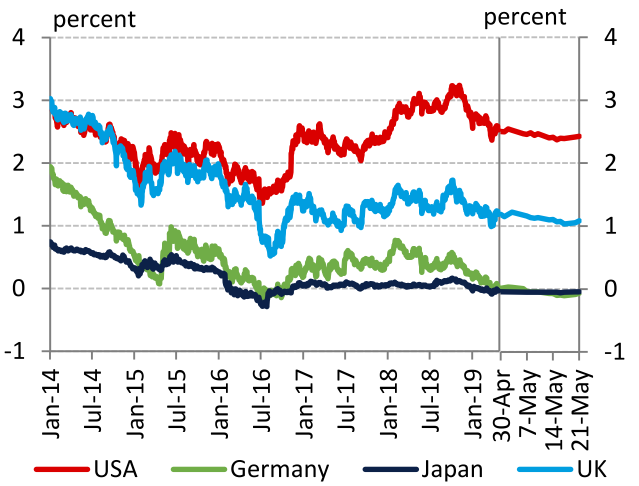
Source: Bloomberg

Investor sentiment slightly deteriorated since the previous interest rate decision (Chart 11). During the period under review, the VIX index rose from 13 percent to 15 percent, and global bond market trends also reflected a rise in risk aversion. The MOVE index, measuring the volatility of the US bond market, rose by 6 basis points in parallel with the deterioration in global sentiment. During the period under review, the emerging market EMBI Global spread registered a moderate, 5 basis point, increase on the whole. It was primarily the deepening of the trade policy tensions that exerted negative impact on market sentiment, since no agreement was reached between the USA and China.

In accordance with the risk averse sentiment, both the developed and emerging market stock exchange indices fell during the period under review. The US and Japanese indices fell by 3-4 percent since the last interest rate decision, while the fall observed in the case of the European stock exchange indices was more moderate, i.e. 1-1.5 percent. The MSCI index representing the developed markets, and the composite MSCI index measuring the performance of the emerging market declined by around 3 and 7 percent, respectively.

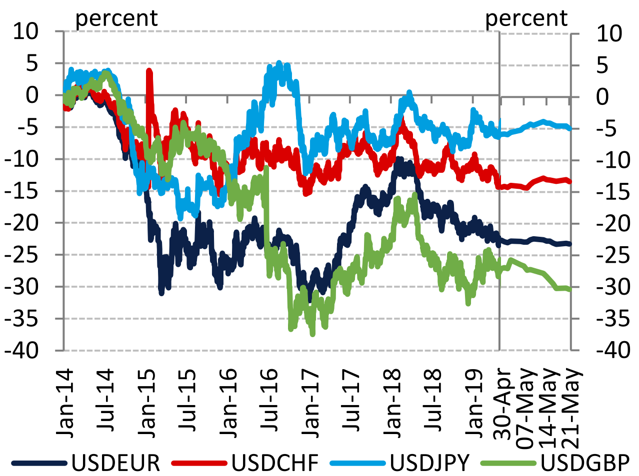
The yields on the developed market long-term government securities declined and the emerging long-term yields also typically decreased (Chart 12). On the developed markets, the US and German long-term yields diminished by 8 basis points , while the Japanese one decreased by 2 basis points. The US ten-year yield was 2.42 percent , while the German and Japanese yields remained close to 0 percent. Emerging bond markets were also characterised mostly by decreasing yields; however, the ten-year yield of Argentine substantially increased, and thus on the whole the emerging market EMBI Global spread closed with a moderate rise compared to its level registered at the previous interest rate decision.

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

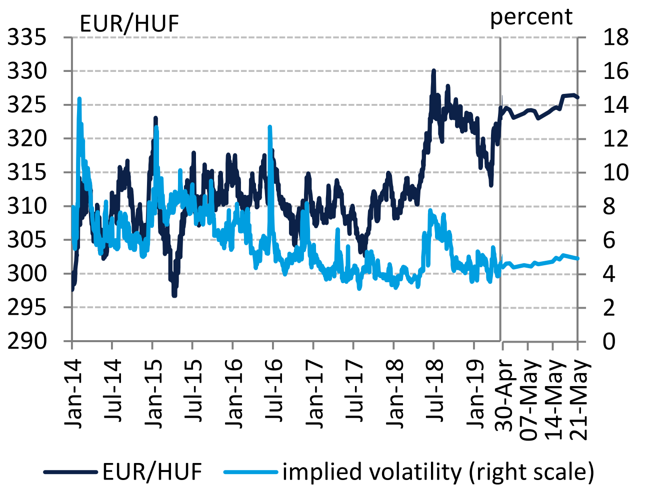
The dollar exchange rate showed mixed performance against the other developed currencies (Chart 13). During the period under review, it stood relatively steady against the euro, while by the end of the period it appreciated by roughly 0.5 percent. The uncertainty around Brexit once again weakened the British pound, and thus it depreciated against the dollar by 2.5 percent. In parallel with this, the risk averse sentiment caused the safe haven currencies – the Swiss franc and the Japanese yen – to appreciate by almost 1 percent against the dollar.

During the last one month, the events reducing the oil price triggered a stronger effect on the oil market, and thus oil prices declined on the whole. Oil prices rose month by month from their more than two-year low recorded at the end of December; at the same time, in May the price of Brent and WTI were 2.9 and 3.5 percent lower, respectively, than a month ago. During the month, the US sanctions against Iran, the Russian oil contamination, and the attacks on the oil tankers and oil wells all contributed to a rise in oil prices. At the same time, news related to the increase in the output by some of the OPEC countries in order to offset the sanctions against Iran, the rise in US oil reserves, the mitigation of the effect of the Russian oil contamination and the downwardly revised estimate of IEA related to global oil demand had stronger oil price reducing effect on the whole.

2.2. Developments in domestic money market indicators

In the period under review, the forint slightly depreciated against the euro. The 3-month BUBOR rose by 4 basis points to 20 basis points. The government securities yield curve became slightly flatter.

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

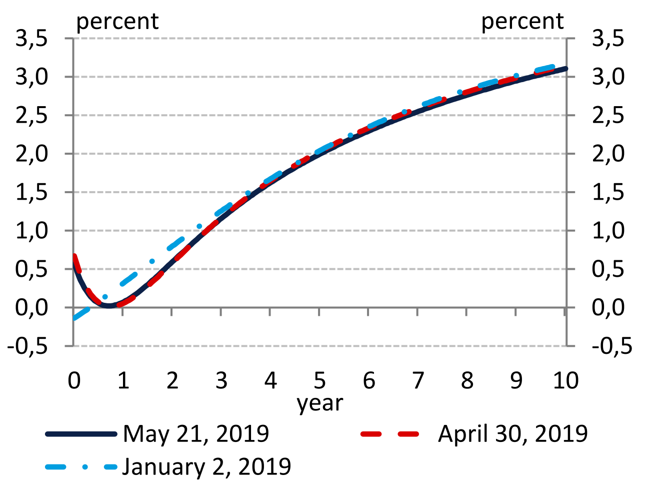


Source: Bloomberg

The forint exchange rate against the euro exceeded 326 in the period under review, and thus it depreciated by 0.7 percent since the April interest rate decision (Chart 14). In May, the forint gradually depreciated, which was mostly attributable to the intensification of the international trade tensions and the global risk aversion resulting from this. The forint depreciated to a slightly greater degree than the currencies of the region, since the Polish zloty, the Czech koruna and the Romanian leu depreciated against the euro by 0.2-0.4 percent in total.

The 3-month BUBOR rose by 4 basis points, and it stood at 20 basis points at the end of the period. **There was only a minor shift in the government yield curve, and similarly to the interbank yield curve it became slightly flatter** (Chart 15). The short section of the yield curve was characterised by a rise of 1-2 basis points, while the middle and long sections registered a decline of 3-4 basis points. As result of this, the government yield curve became slightly flatter during the period under review.

Chart 15: Shifts in the spot government yield curve



Source: MNB, Reuters

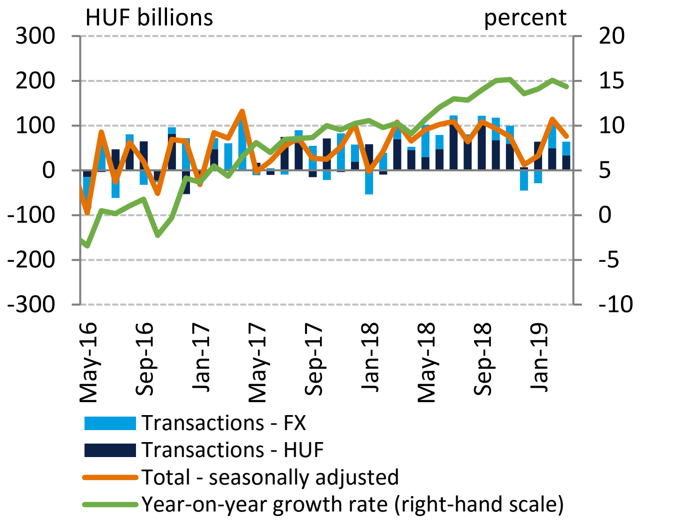
At the forint government bond auctions, due to the poor demand the Government Debt Management Agency reduced the issued volume compared to the announced volume in the case of the short-term securities. Demand for long-term securities were strong, and due to this the Government Debt Management Agency increased the issued volume compared to the announced in some cases. At the auctions of the 3-month Treasury bills the volume of government securities sold fell short of the announced volume on several occasions, and demands were not strong for the 12-month Treasury bills either. The average yield of the 3-month auctions rose to 0.08 percent by the end of the period, which exceeds the yield of the previous period by 8 basis points. At the 12-month Treasury bill auctions, the average auction yield remained 0.2 percent. At the same time, the auctions of the longer term government securities mostly attracted strong demand, and thus in several cases the Government Debt Management Agency accepted higher volumes than previously announced.

The **Hungarian 5-year CDS spread** remained at 85 basis points during the period under review. **Non-residents' forint government securities holdings moderately rose**. Accordingly, the portfolio held by non-residents rose by HUF 32 billion to HUF 4,238 billion, while their share remained close to 23 percent of the market holding.

3. Trends in lending

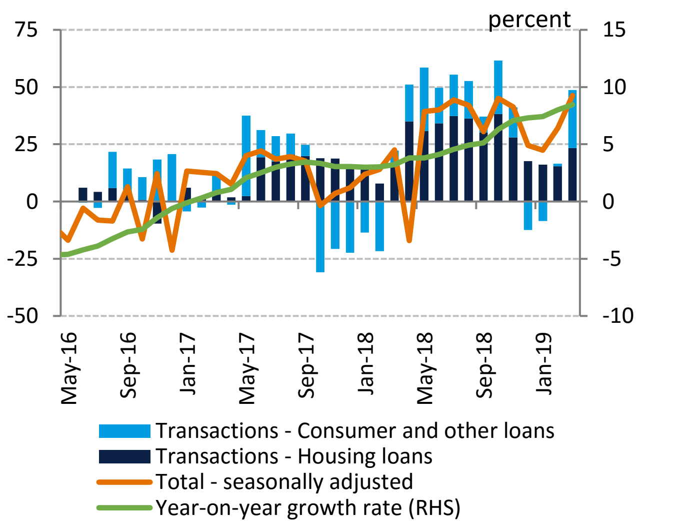
In March, the outstanding corporate loans of credit institutions rose by HUF 64 billion as a result of transactions. The outstanding loans of the credit institutions to households rose by HUF 49 billion, and thus in March 2019 the annual growth in outstanding lending amounted to 8.5 percent.

Chart 16: Net borrowing by non-financial corporations



Source: MNB

Chart 17: Net borrowing by households

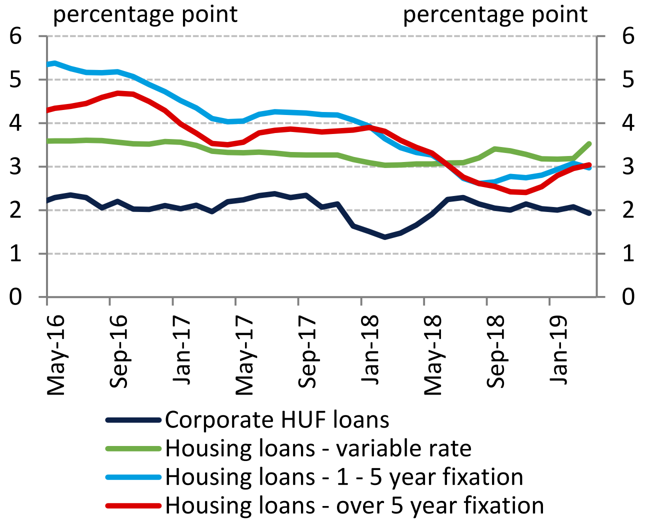


Source: MNB

In March the outstanding corporate loans of credit institutions rose by HUF 64 billion as a result of transactions (Chart 16). In a breakdown by currency, forint loans and foreign currency loans increased by HUF 33 billion and HUF 31 billion, respectively. The annual growth rate of corporate lending declined to 14.3 percent in March. Excluding money market transactions, the volume of new loans amounted to HUF 271 billion during the month.

The outstanding loans of the credit institutions to households rose by HUF 49 billion as result of transactions, and thus they registered a 8.5 percent growth year-on-year growth (Chart 17). The value of new contracts concluded during the month amounted to HUF 160 billion. New loans were still dominated by housing loans (HUF 76 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 March, the ratio of loans with interest rate fixed for more than 1 year rose to 95 percent, while of those fixed for 5 years rose to 70 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 1.9 percent in March 2019, representing a decrease of 10 basis points compared to the end of the year (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 26 basis points compared to September 2017, to 3.5 percentage points. In the case of loans the interest rate of which is fixed for 5 years at the most, this value dropped by 126 basis points to 3 percentage points, while in the case of loans fixed for more than 5 years, it fell by 79 basis points to 3 percentage points, and thus at present the average spread on fixed-rate loans is already below that on the variable-rate loans.